



Special Series on COVID-19

The Special Series notes are produced by IMF experts to help members address the economic effects of COVID-19. The views expressed in these notes are those of the author(s) and do not necessarily represent the views of the IMF, its Executive Board, or IMF management.

December 16, 2020

Legal Considerations on Public Guarantees Schemes Adopted in Response to the COVID-19 Crisis

Ender Emre, Alessandro Gullo, Cristina Müller, Mia Pineda, Mario Tamez, and Karla Vasquez¹

The abrupt economic shock caused by the COVID-19 outbreak disrupted the provision of credit to several segments of the real economy. Several countries put in place public guarantee schemes (PGSs) in favor of creditworthy but temporarily distressed borrowers, aiming to strike a difficult balance between the need to respond promptly to the economic distress and the preservation of sound financial and fiscal practices. This note presents preliminary lessons on the key features of legal frameworks for PGSs that should enhance predictability and promote transparency and accountability, in particular over the use of public funds.¹

LEGAL UNDERPINNINGS AND LEGAL DESIGN FEATURES OF PUBLIC GUARANTEE SCHEMES

PGSs transfer, totally or partially, the risk of default from the lender to the State. They are commonly deployed by countries particularly when market failures prevent or constrain the access to credit by businesses (typically, but not exclusively, small and medium enterprises [SMEs]). During the COVID-19 outbreak, the swift provision of liquidity to distressed enterprises became essential, while it was challenging for lenders to accurately assess the creditworthiness of borrowers through a forward-looking approach. Several countries therefore resorted to PGSs.²

¹ The authors are grateful to Yan Liu, Jose Garrido, and Pasquale Di Benedetto for their comments and to Arthur Rossi for his research. This note draws from the analysis of legal frameworks in selected jurisdictions and has not benefited from a discussion with country authorities. References to country measures are provided merely by way of example.

² Approximately 40 countries—mainly advanced and emerging economies—did so, often with the key purpose of providing liquidity to SMEs. See https://read.oecd-ilibrary.org/view/?ref=119_119680-df6h3qgi4x&title=Covid-19_SME_Policy_Responses. The total available amount of public guarantees on bank loans as a percentage of GDP varies across countries, reaching 25 percent in Germany and Italy and about 15 percent in France and Spain. See also IMF Policy Tracker Responses to COVID-19. This note does not discuss the provision of liquidity by central banks in the context of the pandemic; for a discussion of the legal aspects related to the provision of liquidity by central banks, see the forthcoming COVID-19 Special Series Notes by the IMF Legal Department.

In jurisdictions where PGSs were in place before the COVID-19 crisis, countries made legal changes to adapt these schemes to the needs specifically related to the pandemic (Spain).³ Where there were no guarantee schemes in place, new PGS legal frameworks have been adopted (South Africa). Most jurisdictions enacted primary laws to modify the existing PGS frameworks or to create new schemes, and to authorize the fiscal backstop for the scheme. Other countries relied on secondary legislation, especially where the fiscal backstop was already authorized in primary legislation (Netherlands, Turkey). While these legal avenues depend on country characteristics, PGS legal frameworks should be aligned with the legislation for public financial management (PFM). For instance, the issuance of government guarantees to private parties should be authorized following the processes defined in the public debt management framework. Likewise, general monitoring, reporting, and accountability mechanisms to mitigate fiscal risks should be preserved and adequate fiscal backstops arrangements should be specified in the legal framework to fund PGSs as needed.

The COVID-19 crisis posed several complex challenges owing to the major economic distress it caused, the need to act swiftly to preserve economic stability, and the volume of the guaranteed operations. While established guiding principles for PGSs remain valid, a number of adjustments have been made across jurisdictions to certain features of PGSs, as discussed throughout the note (for example, on risk sharing and fees).⁴ This calls for putting in place safeguards to prevent unsound practices. More generally, a clear and transparent legal framework should underpin the different policy choices that the authorities can make on the operations of a PGS during COVID-19.

Eligibility criteria

- *The categories of eligible borrowers* can include individuals, sole proprietorships, and SMEs. Legal provisions on PGSs adopted during the COVID-19 crisis broadened eligibility to additional categories, such as certain specified industries and large companies operating in strategic sectors. Legal requirements often include a link with the jurisdiction where the State guarantee is provided, such as the conduct of substantial part of the business in the relevant jurisdiction (Belgium), or a minimum of local ownership (for example, in Singapore, a percentage of equity must be held by citizens and/or residents). Most jurisdictions also required that borrowers have a sound financial situation at a specific date preceding the emergence of the pandemic, based on objective criteria.
- *Eligible lenders* typically include commercial banks. However, to address the need for quick provision of liquidity, some jurisdictions expanded eligibility to include nonbank financial entities (for example, electronic money entities and payment services providers in Spain).
- *Eligible loans* mostly involve liquidity financing (for example, bridging loans and overdraft facilities) to cover operational expenses such as salaries, rent, utilities, and ordinary-course supplier payments, rather than investment finance.

Guarantee coverage. Risk-sharing practices for PGSs aim to curtail moral hazard and to provide the correct incentives to both lenders and borrowers, by having a coverage ratio of the government guarantee of the loan amount commonly varying from 50 percent to 80 percent. In response to the severity of the pandemic crisis, some jurisdictions have increased the coverage ratio up to 100 percent in certain cases (for example, vulnerable borrowers, such as the smallest businesses).

Loan size. To ease cash flow problems, virtually all jurisdictions increased temporarily the cap on the size of loans guaranteed under an existing PGS. For this purpose, the legal framework set a limit, based on the type

³ The European Union issued a framework applicable throughout EU member countries: "Temporary Framework for State Aid Measures to Support the Current COVID-19 Outbreak." https://ec.europa.eu/competition/state_aid/what_is_new/covid_19.html

⁴ The World Bank Group and FIRST Initiative. 2015. "Principles for Public Credit Guarantee Schemes for SMEs."

and size of the business (Japan) or on a variable component such as the revenues or estimated payroll of the borrower (France). Some laws allowed the government to authorize case-by-case exceptions to the cap in case of national security interest, job protection, or relevance of the business for the national economy (Belgium).

Loan maturity and terms of repayment. The maturity of the guaranteed loans provided by the COVID-19 legal frameworks varies across jurisdictions, ranging from one (for example, Belgium, in one of the schemes available) to 10 years (for example, for certain loans with limited credit amounts in Germany). Countries may also provide for grace periods for the repayment of loans and/or interests (six months in Australia, 12 months in Peru).

Fees. PGS frameworks typically provide a consistent risk-based pricing policy to ensure that the scheme is financially sustainable. The guarantee fees are usually established in the PGS legal framework rather than on a case-by-case basis, by having a fixed flat fee or a variable one. However, in the COVID-19 crisis certain jurisdictions have set caps on the amounts of fees that can be charged or have forbidden to charge them (United States).

RESPONSIBILITIES FOR ISSUING AND ADMINISTERING GUARANTEES

Although there is an inherent contingent liability in all types of PGSs, the type of exposure may vary. From a legal viewpoint, the existence of an explicit contingent liability for the government will depend on which entity is in charge of the issuance and administration of the guarantee.⁵ PGSs often are established as an independent entity. When they operate through non-independent governmental entities,⁶ adequate governance safeguards should be in place to preserve a sound decision-making process and distinguish the roles of guarantor and fiscal risk overseer. Depending on the particular arrangements, guarantees can be:

- **provided directly by the central government** through, for example, the Ministry of Finance (MoF) or Economy (Spain), the Treasury Department (Belgium), or a governmental agency (Netherlands). To ease the operational burden arising from the high number of guarantees necessitated by the pandemic, the administration of the scheme in some jurisdictions has been delegated to specialized public entities, while the issuance of the guarantee is still on behalf of the State. When guarantees are provided directly by the central government, the State legally assumes a contingent liability.
- **channeled through public independent entities with a separate legal personality.** The guarantee could also be issued by entities outside the central government, such as funds (for example, FOGAPE in Chile), State-owned enterprises (for example, the Hong Kong Mortgage Corporation Insurance Limited), or a corporate structure in partnership with public local entities (for example, local Credit Guarantee Cooperations in Japan). The administration of the PGS could also be delegated to third parties (for example, Chile). While these public entities legally assumed a contingent liability, legislation enacted during the COVID-19 outbreak provided funding to these schemes or authorized explicit fiscal backstops in their favor. Support ranged from capitalization (FOGAPE in Chile), to provision of liquidity (for example, Japan and KGF in Turkey), or a revolving credit facility (for example, Hong Kong SAR). Regardless of the specific entity in charge, the PGS legal framework should clarify: (1) the ownership policy of the government, including who is responsible to

⁵ Recording of the guarantees in fiscal statistics and budget execution reports will need to follow international standards (for example, Government Finance Statistics, International Public Sector Accounting Standards, the European System of Accounts, if applicable) and will vary depending on whether guarantees are considered one-off guarantees or standardized schemes.

⁶ The Principles for Public Credit Guarantee Schemes for SMEs advocate for the establishment of credit guarantee schemes as independent legal entities on the basis of a sound and clearly defined legal and regulatory framework to support the effective implementation of their operations and the achievement of their policy objectives (Principle 1).

represent the government; (2) the government bodies overseeing the PGS, and (3) the relationship between the government—as a shareholder—and the management of the PGS.

ALLOCATION OF ROLES AND RESPONSIBILITIES

PGS legal frameworks should clearly define the roles and responsibilities of the lenders and the public entity in charge of issuing and administering the PGS, as this will impact the allocation of risks. In particular, legal frameworks should clarify that:

- **The lending decision will continue to rest on the sole discretion of the *lender***, who, to prevent excessive risk taking, should *evaluate* (1) the borrowers' creditworthiness, (2) how the guaranteed loan fits into its business and risk appetite, (3) whether the guaranteed loans could be used as collateral to access central bank liquidity facilities,⁷ and (4) the regulatory capital treatment applicable to banks' exposure, as set out in the Basel framework. Although some jurisdictions explicitly require the lenders to adhere to sound underwriting standards (Belgium, Netherlands) or to perform their own credit risk analysis (Chile, South Africa), others require or allow lenders to waive the borrowers' creditworthiness assessment only when no residual credit risk remains with the lender (Germany, Italy, and Switzerland). If the guarantee covers less than the total amount of the loan, waiving this kind of assessment can expose the lender to undue risks.
- **The decision to approve specific guarantees typically lies with the *public entity issuing the guarantee***. To prevent excessive fiscal exposure, legislation on PGS enacted during the COVID-19 crisis require a *case-by-case authorization* by the government *above certain thresholds*, to verify that conditions are met by the PGS administrators (Turkey), or by the MoF, with input from the administrators (France, Italy). Nonetheless, to ensure timely liquidity support, most jurisdictions have allocated the administrative functions that would normally be performed by the existing schemes, by:
 - *Delegating the evaluation of applications*, with lenders reviewing the borrowers' applications and verifying the eligibility criteria.⁸
 - *Simplifying and/or automatic issuance of guarantees*, with a notification by the lender to the government or the registration of the transaction in a designated system triggering the issuance of the guarantee (Chile, Switzerland).

To prevent improper practices and to mitigate fiscal risks, the legal framework should provide adequate safeguards to ensure that guarantees meet the established policy objectives, including transparent and objective criteria to inform the decision-making process, clear distribution of responsibilities with adequate checks and balances, and comprehensive accountability mechanisms. For example, legal frameworks should establish that guarantees may be cancelled when loans do not meet the eligibility requirements (Peru) or when a credit is granted without observing sound practices, in which case lenders may end up bearing the risk of the whole exposure.

ONGOING MONITORING

The monitoring, budgeting, reporting, and disclosing of fiscal risks from PGSs is subject to the general PFM legislation. When schemes are administered by public entities, many PGS legal frameworks vest supervisory powers in one authority—typically the financial sector supervisor. Under COVID-19-related legislation countries

⁷ Various central banks have extended their collateral pools to include credit claims issued under PGSs to provide lenders with the needed funding to grant loans quickly and in large amounts (Peru).

⁸ Legal frameworks may also provide for a presumption of eligibility (for example, that the borrower is affected by the pandemic) and require the lenders to simply rely on the documentation submitted by the borrowers.

have often, and appropriately, established supplementary monitoring responsibilities for both the lenders and the PGS administrators, particularly in relation to the ongoing performance of the guaranteed loan. These typically include:

- **additional obligations for the lender** to report on the fulfillment of eligibility criteria and on loan performance to different stakeholders (for example, the supervisor,⁹ PGS administrator, and MoF); verify any required use of loan proceeds; exchange information within relevant public entities; and report called guarantees. The framework agreements between the PGS administrator with the lenders would outline these obligations. Furthermore, to minimize uncertainty, the legislation must establish the legal consequences of noncompliance with the reporting requirements, for instance, if the enforcement of guarantees is impacted in case of nonreporting by the lender.
- **additional obligations for PGS administrators**, such as the requirement to seek authorization from the government for specific actions, for example, in case of amendments to repayment schedules or suspension in the payment of commissions, or for the disclosure of information on the use of the guarantees, or loan performance.

This enhanced monitoring may also serve to timely assess how the PGSs are achieving their policy objectives and thus to recalibrate their design elements, for instance with respect to the ceilings for the issuance of guarantees or to the coverage. In countries where PGSs are established under emergency legislation, the mandatory reporting at the expiry date of the PGSs allows for a transparent process by which parliaments can assess whether the PGSs should remain in place or, alternatively, consider exit strategies (United Kingdom).

Accountability is also strengthened by COVID-19 laws by assigning specific duties to legislative committees and special inspector generals (United States) or establishing ad hoc committees (France, Italy).

DISTRIBUTION OF LEGAL RISKS

Given the early implementation stages of the PGSs and the different legal design features, it seems premature to draw general conclusions on the execution of guarantees and on how the allocation of risks would materialize. However, to minimize legal uncertainty, the legal framework for PGSs and the contractual arrangements should clearly define the legal relationship among the State, the lender and the borrower. Notably, it is essential to determine the terms and conditions under which the State will be called to make payments. In some countries, guarantees issued by a PGS are considered first demand guarantees, where the guarantor's obligation is independent from the underlying debt (Italy, United States). In others, the State has a subsidiary liability (France, Netherlands), whereby the enforcement and/or validity of the guarantee is dependent on that of the principal debt, but a provisional payment by the State to the lender may be made based on expected losses after a default. If the enforcement of guarantees by lenders is linked to the occurrence of "losses," clarity is needed on when and how such losses will be deemed to exist and borne by the lenders.

In addition, there must be clarity on the rights of the State after it makes payments under the guarantee. The general legal principle of statutory subrogation entitles the State to claim the paid amount from the borrower. Depending on the coverage of the guarantee, both the lender and the public entity issuing the guarantee may have a claim against the borrower. Some jurisdictions seek to increase efficiencies in recoveries by requiring the lender to act as the agent of the State during the enforcement stage (Chile).

THE ROAD AHEAD

The severity of the pandemic and the sheer volume of guarantees may affect how the appropriate balance can

⁹ Adherence to prudent risk management principles is also monitored by prudential supervisors.

be struck between swift and effective financing and financial and fiscal prudence across jurisdictions. While PGSs are at an early stage of implementation, legal frameworks can play an important role in promoting transparency and accountability, mitigating fiscal risks, and supporting their policy objectives to tackle the COVID-19 crisis. Strictly adhering to the established general principles for PGSs might prove challenging due to the abrupt economic shock caused by the pandemic. However, when adjustments are required, the legal framework should include adequate safeguards to prevent unsound practices. Hence, jurisdictions that aim to amend or introduce a PGS should:

- establish sound legal underpinnings that set up the core features of the PGS and provide clear, transparent, and objective criteria guiding the decision-making of the relevant stakeholders
- define institutional arrangements that effectively support the implementation of PGSs
- unambiguously delineate the roles and responsibilities of the different parties involved, require the observance of good practices, and introduce adequate safeguards when departures are needed
- enhance monitoring and reporting mechanisms, as well as independent and effective supervision proportional to risks
- increase accountability and transparency requirements, in particular regarding the use of public resources
- establish a rigorous post assessment of the performance and cost effectiveness of PGSs, through the availability of appropriate data, and publicly disclose its findings

Looking forward, jurisdictions should enhance their preparedness and consider having in place a well-designed legal framework for a PGS that can be deployed immediately at the occurrence of future crisis events (for example, natural disasters or pandemics).¹⁰ Once COVID-19-related PGSs expire, authorities should undertake a thorough assessment on how PGSs perform in fulfilling their policy goals and disclose the main findings.

Against the backdrop of the pandemic crisis, if financial and economic distress persist a wave of defaults and enforcement of guarantees may be significant. The authorities will need a comprehensive strategy to address the potential financial stability risks and fiscal strains that may arise if the number of called guarantees were to be significant and to manage the enforcement of the defaulted loans, both from a fiscal and supervisory standpoint. Some countries are already evaluating possible ways to address these critical issues without waiting for the materialization of contingent liabilities.¹¹ Discussions have started to take place on the shift from “debt-like” to “equity-like” support and on other measures tailored to the size and systemic significance of firms that have benefited from state guarantees. Recognizing that the availability of fiscal space will determine the breadth of the stimulus measures, steps to support the real economy should ideally focus on repairing balance sheets by reducing the leverage of firms and helping them repay government guaranteed debt in a sustainable manner.¹² Doing so will support businesses and help preserve jobs and growth, while protecting taxpayers.

¹⁰ For instance, after the Fukushima earthquake and tsunami of March 2011, Japan established a facility and allocated resources that can immediately be employed to provide guarantees to designated financial institutions during crisis situations.

¹¹ See on this matter the toolbox proposed by the recapitalization technical working group in United Kingdom: <https://www.thecityuk.com/assets/2020/Reports/2d5179dbfb/Supporting-UK-economic-recovery-recapitalising-businesses-post-Covid-19-v2.pdf>

¹² See COVID-19 Special Series Note by the IMF Legal Department “Private Debt Resolution Measures in the Wake of the Pandemic.”

REFERENCES

- Anderson, J., E. Bergamini, S. Brekelmans, A. Cameron, Z. Darvas, M. Domínguez Jiménez, and C. Midões. 2020. "The Fiscal Response to the Economic Fallout from the Coronavirus." Bruegel.org, Brussels. <https://www.bruegel.org/publications/datasets/covid-national-dataset/>
- Anderson, J., F. Papadia, and N. Veron. 2020. "Government-Guaranteed Bank Lending: Beyond the Headline Numbers." Bruegel.org, Brussels. <https://www.bruegel.org/2020/07/government-guaranteed-bank-lending-beyond-the-headline-numbers/>
- Bank for International Settlements. 2006. "Corporate Credit Guarantees in Asia." Quarterly Review Special Features Series. Basel. https://papers.ssm.com/sol3/papers.cfm?abstract_id=1632358#
- Baudino, P. 2020. "Public Guarantees for Bank Lending in Response to the COVID-19 Pandemic." Bank of International Settlements, Basel, April. <https://www.bis.org/fsi/fsibriefs5.pdf>
- Blanchard, O., T. Philippon, and J. Pisani-Ferry. 2020. "A New Policy Toolkit is Needed as Countries Exit COVID-19 Lockdowns." Peterson Institute for International Economics, Washington, D.C. <https://www.piie.com/publications/policy-briefs/new-policy-toolkit-needed-countries-exit-covid-19-lockdowns>
- Borio, C., and F. Restoy. 2020. "Reflections on Regulatory Responses to the COVID-19 Pandemic." Bank of International Settlements, Basel. <https://www.bis.org/fsi/fsibriefs1.pdf>
- The City UK. 2020. "Supporting UK Economic Recovery: Recapitalising Businesses Post COVID-19." London. <https://www.thecityuk.com/research/supporting-uk-economic-recovery-recapitalising-businesses-post-covid-19>
- The Commission of European Communities. 1971. "The Suretyship in the Law of Member States of the European Communities." Hamburg. <http://aei.pitt.edu/34400/1/A768.pdf>
- European Banking Authority. 2020. "Overview of Public Guarantee Schemes Issued in Response to the COVID-19 Pandemic." Paris. <https://eba.europa.eu/eba-publishes-overview-public-guarantee-schemes-issued-response-covid-19-pandemic>
- European Commission. 2020. "Temporary Framework for State Aid Measures to Support the Economy in the Current COVID-19 Outbreak – Consolidated Version." Brussels. https://ec.europa.eu/competition/state_aid/what_is_new/TF_consolidated_version_amended_3_april_8_may_and_29_june_2020_en.pdf
- European Investment Fund. 2017. "Credit Guarantee Schemes for SME Lending in Western Europe". Luxembourg. https://www.eif.org/news_centre/publications/EIF_Working_Paper_2017_42.htm
- Gergerli, I. 2019. "Hidden Power of the Japanese Economy – Credit Guarantee Corporations." Ankara. https://www.smefinanceforum.org/sites/default/files/Hidden_Power_of_the_Japanese_Economy_book.pdf
- The Graduate Institute of Geneva. 2020. "COVID-19 in Developing Economies." Geneva. https://voxeu.org/content/covid-19-developing-economies?utm_source=hootsuite&utm_medium=&utm_term=&utm_content=&utm_campaign=
- International Monetary Fund (IMF). 2017. "How to Strengthen the Management of Government Guarantees." Washington, DC. <https://www.imf.org/en/Publications/Fiscal-Affairs-Department-How-To-Notes/Issues/2017/10/19/How-to-Strengthen-the-Management-of-Government-Guarantees-45201>
- International Monetary Fund (IMF). 2019. "Fiscal Transparency Code." Washington, DC. <https://www.imf.org/external/np/fad/trans/Code2019.pdf>
- International Monetary Fund (IMF). 2020. "Policy Tracker: Economic Responses to COVID-19 by Countries." Washington, DC. <https://www.imf.org/en/Topics/imf-and-covid19/Policy-Responses-to-COVID-19>
- International Monetary Fund (IMF), 2020, "Private Debt Resolution Measures in the Wake of the Pandemic." Washington, DC. <https://www.imf.org/en/Publications/SPROLLS/covid19-special-notes#Legal>
- Organisation for Economic Co-operation and Development (OECD). 2020. "Coronavirus (COVID-19): SME Policy Responses." Paris. <http://www.oecd.org/coronavirus/policy-responses/coronavirus-covid-19-sme-policy-responses-04440101/>
- World Bank Group. 2008. "The Typology of Partial Credit Guarantee Funds around the World." Washington, DC. <https://elibrary.worldbank.org/doi/pdf/10.1596/1813-9450-4771>
- World Bank Group. 2015. "Principles for Public Credit Guarantee Schemes for SMEs." Washington, DC. <https://documents.worldbank.org/en/publication/documents-reports/documentdetail/576961468197998372/principles-for-public-credit-guarantee-schemes-for-smes>
- World Bank Group. 2020. "Boosting Credit: Public Guarantees Can Help Mitigate Risk during COVID-19". Washington, DC. <https://blogs.worldbank.org/psd/boosting-credit-public-guarantees-can-help-mitigate-risk-during-covid-19>

World Bank Group. 2020. "Map of SME-Support Measures in Response to COVID-19." Washington, DC.

https://dataviz.worldbank.org/views/SMECOVID19/Overview?%3Aembed=y&%3AisGuestRedirectFromVizportal=y&%3Adisplay_count=n&%3AshowAppBanner=false&%3Aorigin=viz_share_link&%3AshowVizHome=n&fbclid=IwAR0vfwIVUpPgT9qn7w9473B7hyi8mVIB4PZVkosOLRJCQR6NgS1ZJPeR5qM