

RAP

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Espaço dedicado à divulgação dos programas de pesquisa e de estudos e análises sistemáticas levados a efeito pela comunidade acadêmica da Ebape/FGV.

Small business através do panóptico

A conjuntura das escolhas públicas

Small business através do panóptico

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A PARTIR DA IDEIA DE “OBSERVAÇÃO TOTAL” DE JEREMY BENTHAM (1748-1832), ESTA SEÇÃO TEM COMO PROPOSTA SER UM ESPAÇO DEDICADO À DIVULGAÇÃO DE ESTUDOS E PESQUISAS RELACIONADOS AO CONCEITO DE *SMALL BUSINESS* E SUSTENTABILIDADE, QUE ENGLOBA, ENTRE OUTRAS, AS SEGUINTE TEMÁTICAS: MICRO, PEQUENAS E MÉDIAS EMPRESAS (MPMEs); EMPREENDEDORISMO; JOVENS EMPRESÁRIOS; ACESSO AO CRÉDITO; MICROFINANÇAS; MEIOS DE PAGAMENTO; INCUBADORAS; DESENVOLVIMENTO LOCAL; RESPONSABILIDADE SOCIOAMBIENTAL.

Credit guarantee systems for small enterprises under scrutiny: the case of the German Buergschaftsbanken

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SUMMARY: 1. Introduction; 2. Theoretical analysis; 3. Guarantee banks to boost the real economy in Germany; 4. Conclusions.

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1. Introduction

German Guarantee Banks (*Buergschaftsbanken*) are public-private partnerships with the objective to ensure that finance for sound small businesses should not fail because of missing collateral. Therefore, Guarantee Banks (GBs) provide guarantees to commercial banks for loans to small and medium-sized enterprises (SMEs). In case of the borrower's default, the GB provides a financial compensation for the bank if receipts from a possible liquidation of the enterprise and its collateral do not cover the amount of the bank's outstanding loan. Before guaranteeing the loan, each individual request is analysed by the GB with its own methods, based on its own sources of information and experience. This is a key component of the whole set-up, because the main reason for credit rationing — or why banks reject sound loan applications by SMEs — is information asymmetry between bank and borrower (Stiglitz and Weiss, 1981).

First German predecessors of Guarantee Banks emerged in the beginning of the 20th century (Fischer, 1959). However, only after World War II, did they become relatively important; they emerged on initiative of chambers of craftsmen (*Handwerkskammern*), chambers of commerce and industry, and banks as well as the government on different levels. They played an interesting role in the (re)construction of the German financial markets (Giebitz, 1987), mostly in form of sectorial credit guarantee societies under the umbrella of local and State chambers of craftsmen, commerce and industry, before being merged and restructured into today's GBs.

Due to the recent financial and economic crisis, many policy makers fear a credit crunch. Therefore, among several other instruments such as "bad banks" or measures to stabilize financial institutions, credit guarantee schemes for loans have been founded or strengthened as countermeasures all over Europe (EU, 2004:24). In Germany, the credit guarantee package amounts to additional guarantees of € 75bn, in addition to further subsidised loans of € 40bn for bigger firms and loans that are guaranteed by the government and provided by the national development bank (*Kreditanstalt fuer Wiederaufbau* — *KfW*). In the UK, the volume of additional guarantees amounted to £ 20 bn (ca. € 22.3 bn). Beyond Europe and OECD countries, the central government of Brazil has also started releasing R\$ 4 bn (ca. € 1.6 bn) of funding for an additional credit guarantee programme (Presidência da República, 2009). A lot of other countries have introduced similar schemes in the recent turmoil, mostly building upon existing credit guarantee mechanisms (AECM, 2009).

In Latin America, there is a variety of credit guarantee schemes for small businesses. Most schemes have already been built before the current worldwide financial and economic crisis, and many institutions are organised within the Iberoamerican network Regar (*Red Iberoamericana de Garantías*). For 14 years, Regar (2009) has organised congresses for practitioners, which are open for academics as well (Nitsch and Kramer, 2009).

In Brazil, beside the current initiative of the central government, vigorous institution building of local credit guarantee societies has been initiated by the Brazilian Support Service for Micro and Small Enterprises (*Serviço Brasileiro de Apoio às Micro e Pequenas Empresas — Sebrae*) (Santos, 2006; Zica, 2008). The aim is the creation of a national system including local mutual credit guarantee associations with formal SMEs as members. The new institutions are to provide guarantees in order to improve finance of the associations' members. Since various surveys, not only in Brazil, show that missing collateral is one of the main obstacles for SME finance, expectations with respect to outreach and overall impact of these new institutions are quite high. Within the initial phase, Sebrae provides technical and financial support to cover starting costs and in addition, it allocates funds to a specific bank account in order to provide collateral for the associated SMEs' loans. These funds are supposed to cover the first payments on called guarantees and to bring robustness to the scheme through increased credibility and payment capacity. Beside the SMEs themselves, public and private institutions – such as municipalities, local SME associations or financial institutions – are invited to contribute to the institutions' equity or to the local credit guarantee funds. Financial sustainability of the institution is required in the long run; that is of crucial importance, because Sebrae's financial support is only temporary and allocated funds have to be reimbursed (Sebrae, 2008).

In development finance, it has become a general lesson learned that it makes sense to provide initial financial and/or technical support for the building of financial institutions, but not to give grants or money-losing loans to so-called “beneficiaries”. Financial institutions are to receive public aid to provide financial service to their clients, but they should soon be able to cover their total costs and hence be basically financially self-sustainable. This “Commercial Approach” — which does not mean to maximise the rate of return but to achieve financial sustainability — has turned out to be sustainable (Nitsch and Santos, 2001; Nitsch, 2008; Nitsch and Kramer, 2009). It is within this general picture that the Guarantee Banks in Germany are presented in the

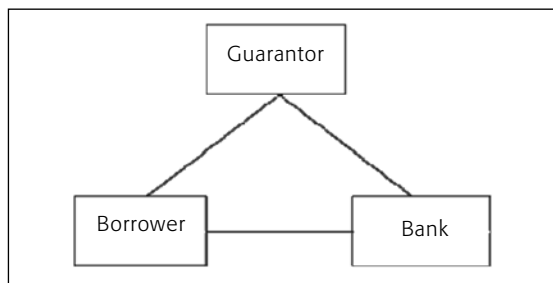
following paper, based on a recent empirical master (diploma) thesis (Kramer, 2008) about those GBs in Berlin and the surrounding Federal State of Brandenburg. General theoretical and conceptual considerations (section 2) are followed by an analysis of the scheme's institutional structure and its implications (section 3). Finally, the conclusions provide some lessons learned.

2. Theoretical analysis

The basic triangular relationship

Within any credit guarantee scheme, the basic loan relationship between borrower and bank is extended through a third party, the guarantor. Whereas the *financing*, meaning the provision the liquidity, remains with the bank, the *credit*, i.e. the trust, confidence and risk of default, is shared among bank and guarantor. Hence, the loan relationship between borrower and bank is augmented to a triangular relationship in which the guarantor assumes part of the risk which would otherwise lie with the bank.

Figure 1
The basic triangular relationship



This triangular relationship can be a complex arrangement between three actors due to their embeddedness into larger social structures as well as information and power asymmetries. Therefore, we provide a brief illustration of the relationships between bank and borrower, guarantor and borrower, and bank and guarantor.

Within the triangular relationship, the loan is the essential link between bank and borrower. The interest rate and its possible reduction due to the

guarantee are important issues for the bank and the borrower. However, there are further transaction costs within the process of screening and monitoring, and the loan has to be seen within the whole business partnership between the bank and borrower, especially in the case of universal banks practising relationship-banking (*Hausbank*) as is the normal state of affairs in Germany. In contrast to banks that practise arm's length banking, the *Hausbank* is the main lender to a firm, and accumulates intensive information on the borrower over time due to repeated interaction — not only loans to the firm but all kinds of financial services to the firm, the management and often also the family of owners. Hence, the *Hausbank* is generally in a good position to evaluate any loan request rather quickly, and furthermore, the loan is only one part of the total business-bank relation, which could easily end after an unjustified rejection of the loan request.¹

Concerning the ties between borrower and guarantor, there is always some kind of fundamental relationship which explains why the guarantee is provided for the borrower's loan. The most normal guarantor in SME-bank relations is the spouse and perhaps one or more other family members — in order to avoid moral hazard with regard to portfolio reshuffling between family members in the case of financial problems of the family-led enterprise in question. There are also other private individual guarantors possible, be they clients or suppliers, neighbours or just friends of the borrower. However, those cases are not being followed here, since our interest lies with institutional structures of guarantee schemes. Similar to relationship-banking, there can be a long-term arrangement between an institutionalised guarantor and the borrower where the guarantor accumulates information on the borrower over time. Consequently, there can be a relationship through which the borrower can enhance his or her bargaining position against the banks. In the extreme case, the borrower can obtain financing without any bank, e.g. via the bond market. However, guarantees can be provided at an arm's length as well. In general, it should be clear that any kind of guarantee reduces the risk for the bank so that *ceteris paribus* its conditions could be eased or perhaps the loan contract would not at all be possible without that collateral. It should also be borne in mind that the borrower has to pay a price for this service, often not in monetary terms, but not necessarily a less costly one. In a historical perspective, institutional self-help has often emerged in order to avoid dependency re-

¹ More theory, discussion, and empirical evidence on the German *Hausbank principles*, is provided in Elsas and Krahn (2004:197-232).

lations resembling debt peonage between borrowers and their more powerful and rich personal guarantors.

The fundamental reason for the relationship between bank and guarantor is the guarantee which reduces or almost abolishes the bank's risk of default, thus easing capital requirements according to bank regulations. Furthermore, the bank can obtain additional information or simply a second due-diligence. Consequently, this "double screening" can increase transaction costs significantly. To reduce these costs, the bank can establish a long-term guarantor-bank relationship where repeated interaction reduces information asymmetries. Analogous to the *Hausbank*-SME relationship, long-term confidence can be created between bank and guarantor. On the other hand, when there is relationship-lending, SME and bank can decide whether an additional guarantee is required so that they may shop for an arm's length guarantee. In principle, the SME's business risk is not reduced by the guarantee; however, two monitors instead of only one are now observing the SME, and in cases of unforeseen risks and dangers, they are prone to warn the borrower because it is in their own interest. Usually, the contract is in the form of a more or less modified deficiency guarantee, i.e. the guarantor is only liable insofar as the bank has a deficiency on its claims for payments. In most cases, the bank receives a financial compensation only after the borrower has defaulted. Often, legal actions against the borrower have to be taken. But there may also be further provisions for cases of insolvency without liquidation of the enterprise and private bankruptcy, and with an early involvement of the guarantor, the so-called "protracted default".

Confidence between the contracting parties is of crucial importance, because information asymmetries exist on all sides. The bank has to evaluate the ability and willingness to pay of the borrower as well as the guarantor; the guarantor has to verify the same from the borrower's side, and the bank as well as the guarantor have to rely on the borrower's information with regard to the use of funds and also his or her ability and willingness to repay. For the bank, it is important to know whether the guarantor has good or even better information or methods to screen the borrower and/or to put pressure on him or her in case of unwillingness to pay. Furthermore, the exact circumstances of the occurrence of loss such as delayed payments or insolvency have to be defined. Equally important, agreements must be made regarding the amount and time of payment, should the event occur. For example, should interest rates be included, and who has the claim on remaining collateral? Consequently, since confidence among all participants is important, it can be rational to establish

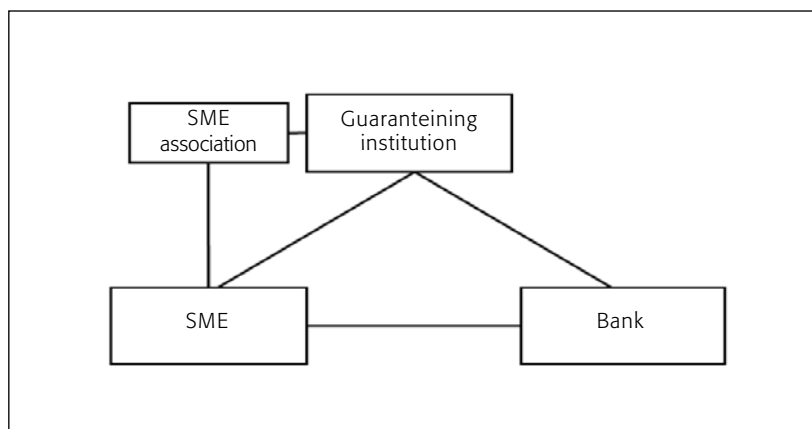
long-term relationships, be they bank-borrower, guarantor-borrower, guarantor-bank, or even tripartite vis-à-vis the government.

Since information asymmetries do exist, there can be moral hazard problems, windfall gains, and furthermore, adverse effects that contradict initial aims. Such problems are described more precisely by Levitzky and Prasad (1985), Seibel (1995) and Guerra de Araújo (2004).

Public and private initiatives providing guarantees

Among more than 2,000 institutions worldwide (Green, 2003), there are many ways to design a credit guarantee scheme. Private initiatives usually take the legal form of mutual credit guarantee associations or guarantee cooperatives (von Stockhausen, 1988:12), where chambers of commerce and industry or farmers, craftsmen and regional or sectorial associations take the initiative. Their aim is to improve conditions and access to credit for their members. Directly and/or indirectly, borrowers are the owners of the guaranteeing institution. In addition, large enterprises can take the initiative to support their business partners such as clients, suppliers or subcontractors. As a result, the basic triangular relationship is extended by including the SME association (by which we mean chambers as well). In addition, the “guarantor” is defined more precisely as a collective, namely the guaranteeing institution, and the borrower is henceforth the SME.

Figure 2
Triangular relationship with SME association



The advantage of this type of private initiative is its business spirit, with which it is to inculcate the whole set-up, and its social proximity to the borrower resulting in a reduction of information asymmetries. The guaranteeing institution might have better information on the market, the investment project, and on the borrower (and his family members personally) thus reducing the borrower's moral hazard. On the other hand, the essential question of financial sustainability is hard to solve for a necessarily rather small institution that mainly provides guarantees to its personally known members. According to Zeiting and Schmidt, these credit guarantee schemes also have a marked disadvantage in comparison with banks concerning the diversification of credit risk because they are often limited to only one sector (Zeiting and Schmidt, 1984). Moreover, every bank is already a kind of credit guarantee fund, because the bank bears its risks of default with its equity and reserves. Above all, members of credit guarantee schemes based on personal relations tend to be hesitant and/or unable to endow their guaranteeing institution with enough money and power to cope with serious default losses, the common problem of collective action in favour of common or public and quasi-public goods.

Self-help schemes presuppose some kind of fraternity between the members of the association in question, which might be true for guilds and other traditional peasant-farmer and craftsmen associations facing atomistic markets. Larger and medium-sized enterprises, and even small ones facing some kind of competition, might not want to share too much business and banking information with others so that cooperation among borrowers has its limits. In any case, the argument of competition reminds one of the general necessity that information flows and decision-making procedures must provide firewalls which protect business plans and financial statements from being spied upon by competitors.

Risk-sharing schemes arise not only from the side of the borrower but also from the banks. Since their associations always comprise competing, oligopolistic rivals, not "brothers", no collective guarantor can be expected from their side. There are only a few exceptions to this rule, such as groups of credit unions or savings banks with statutory limitations to their respective district territories so that they are brothers and sisters, being in a position to form powerful second-tier institutions for auditing, training and also guarantee schemes, such as the credit cooperatives in Germany.

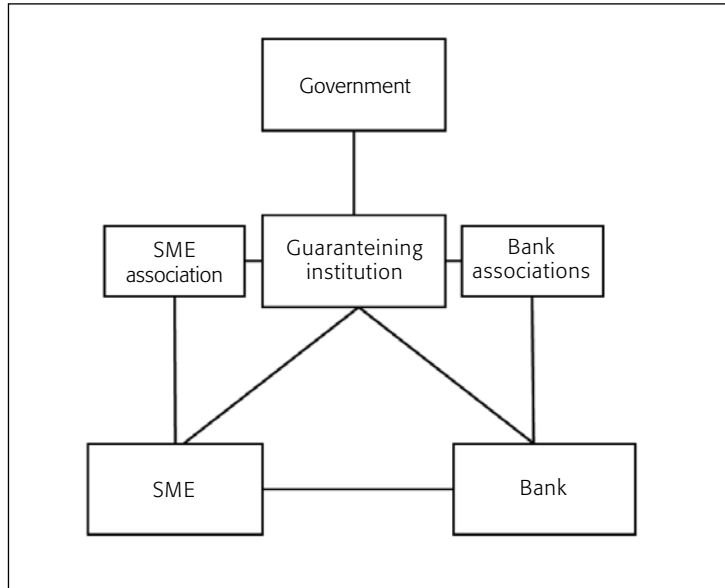
For commercial banks, the usual way to spread credit risks on private grounds is insurance, i.e. absorbing default risks through the law of large numbers, as well as securitisation and access to refinancing sources, from

development banks to the central bank and finally, as we have learned in this crisis, bail-outs by ministries of finance. With regard to credit guarantee schemes, not much financial support can be expected from the side of banks and their associations, and confidentiality and firewalls protecting the bank secrecy can be expected to be high on the agenda, when those schemes are being designed; however, the installation of public-private partnership guarantee schemes with public money will normally be welcomed.

All over the world, public initiatives for the establishment of guarantee schemes are often taken by politicians, public administration agencies or specialised public institutions such as development banks. These initiatives can take place at local, regional, national or even international levels. Within the range of different instruments for public support of economic development, providing guarantees is only one out of many policy options. Contrary to typical policy options such as business services and grants, guarantees are contingent liabilities, and there are losses of an uncertain amount that have to be paid affecting budgets in the future. Hence, public administrators might fear justifying the guarantee and not coping with the budget expenditure in the future, and they may be extremely risk averse. On the other hand, guarantees enjoy rather wide political popularity, because current budgets, the politicians' and administrators' main preoccupation, are normally not burdened, and time horizons tend to be short so that the dates of default and payments honouring guarantees, may lie outside their period of office. That is why euphoric guarantee programmes sometimes emerge, especially in times of crises, so that a sober and critical, somewhat detailed analysis of public initiatives to provide guarantees is particularly pertinent in present times.

Figure 3 shows the basic triangle, with the usually well-informed, but poor, "brotherly" SME self-help association on the left, and the bankers' association of competing, oligopolistic rivals with its main common interest in public support on the right hand side. On top, the government and its financial resources, be it municipality, Federal State/province or nation, and even an international cooperation donor, with its political objective to foster economic development in a certain geographically circumscribed area. In addition, those financial resources are normally made available without requiring financial profit, which makes them all the more valuable for the other participants of the system, but at the same time usually not really prone to accumulation and growth of the credit guarantee scheme itself, since in the next periods there might be risk aversion and/or no willingness for further public spending.

Figure 3
 Triangular relationship with SME and bank associations, and government



This diagram can be understood as the typical general framework for credit guarantee schemes. Dominance, ownership and influence between the parties can vary widely. In addition, not all elements, beyond the basic triangular relationship, are always required to be present in every scheme.

Public authorities are usually prepared to spend some money, but they usually do not have more or better information about SME borrowers than banks. Tax offices, for example, are normally confronted with numbers showing earnings as low as possible, whereas banks have to deal with the opposite. Neither one is really reliable, nor the “middle way”, and not even the borrowing SME businessman or businesswoman him or herself, let alone the micro entrepreneur, might be able to make realistic numerical calculations, because collection and accounting of numbers is often tilted toward information either for the tax authorities or the bank. Fortunately, *homo sapiens* and *femina sapiens* are able to do successful SME business, even if the numbers in their accounts are not too reliable. Thus, information about their personality and their personal competence becomes all the more important. And on the other hand, their scepticism toward tax authorities should be taken seriously

so that the institutional set-up of public-private partnerships has to provide trustworthy firewalls in that direction, too.

Which kind of borrowers will finally receive the support of the scheme depends strongly on who takes the initiative, who are the main stakeholders, and who sits in the driver's seat assuming de facto ownership of the guaranteeing institution. Since owners always have their own agendas, they might try to support only their special "target-group". On the other hand, when the guaranteeing institution remains too open or neutral, especially when it is a joint venture of too many actors with diverging agendas, its executive management is often unable to assume the kind of ownership which is essential for a dynamic business.

Summing up, private SME self-help initiatives can provide useful information, but they normally lack financial resources, whereas public initiatives have the resources, but lack additional information in order to overcome the information asymmetries which typically hamper the financing of SMEs. The question is: can there be a positive public-private partnership combination of the two? And are the German Guarantee Banks a model for such a combination?

3. Guarantee banks to boost the real economy in Germany

Guarantee schemes in Germany

In Germany, there is an astonishing variety of credit guarantee schemes. For example, there are special export guarantee schemes, such as the best known Foreign Trade and Investment Promotion Scheme, the Euler Hermes Export Guarantees (BMW, 2009), and several *ad-hoc* credit guarantees, such as the deficiency guarantee to finance the new airport in Berlin-Brandenburg (Land Berlin, 2008). Those guarantees for exports and large project loans are usually destined for larger and medium-sized enterprises — even though many sub-contracts may be held by SMEs.

Guarantees can be assigned by every ministry of the Federation, every Federal State, and every municipality. Whereas municipalities usually provide *ad-hoc* guarantees (*Kommunalbuergschaften*) many Federal States have implemented credit guarantee schemes (*Landesbuergschaften*) that are usually managed, without any risk-sharing, by private consultants or development banks owned by the Federal States. Sometimes, chambers and SME-associations participate in the decision-making process and the guarantee committees as well.

Furthermore, usually for larger enterprises, guarantees of the Federal States can be accompanied by coexisting guarantees of the Federation (*Buergschaften des Bundes und der Laender*).

Concerning small business finance, public development banks normally provide certain directed soft loans via commercial banks. The risk of default usually remains with the commercial bank. However, there are some loan programmes with special political appeal, where the commercial banks are totally or partially released from the risk of default (*Haftungsfreistellungen*). Furthermore, there are several schemes for micro-enterprises, such as the *Mikrofinanzfonds Deutschland*, a public-private credit guarantee fund, where a specialized local institute consults, screens and monitors the potential borrower, and participates in the risk of default (Mikrofinanzfonds, 2009).

There are some private guarantee schemes as well. For example, the DZBank, one of the two second-tier banks within the “fraternal” German cooperative banking group, provides the credit guarantee “Standard-Meta” to its member banks (Kern, 2008:57). That is a scheme in which the second-tier DZBank relies on the cooperative bank’s information only. Furthermore, Germany’s largest food retailer Edeka, which is also structured as a cooperative, features an exclusive credit guarantee society for its (new) members, the *Edeka Kreditgarantiegemeinschaft* (Edeka Bank, 2009).

There were also various small credit guarantee societies on the local level, usually around chambers of crafts, commerce and industry, which could be described as self-help institutions, supported by the government — with the characteristics described above. Because they were small-scale, and their “fraternity” eroding, nearly all of them have merged in the last four decades within their Federal States, forming the basis of a Guarantee Bank (*Buergschaftsbank*). After the German reunification, only Guarantee Banks were built in the new Federal States. It is these institutions which are to be analysed in the following sections.

A brief introduction to Guarantee Banks in Germany

As a response to the current financial and economic crisis, GBs have recently received more public support through a series of measures so that they can provide guarantees of a higher volume. However, this section mainly gives an overview of the scheme as it stood before the financial crisis.

Within their respective Federal State, Guarantee Banks (GBs) basically provide deficiency guarantees of up to 80% of the loan amount to improve or

even enable the access of SMEs to bank loans. GBs do not work sector specific, with the exception of one special GB for social projects, and the sectors of agriculture as well as coal are also excluded because of their special public promotion systems. Table 1 illustrates the sectorial distribution of the guarantees provided in 2008.

Table 1
Sectorial distribution of guarantees provided by German GBs in 2008

Sector	By number (#)				By volume in €m			
	2008		2007		2008		2007	
Craftsmen	1,631	24%	1,775	25%	208	19%	215	19%
Trade	1,586	23%	1,706	24%	238	22%	232	20%
Industry	907	13%	1,076	15%	231	21%	302	26%
Others/Services	1,597	24%	1,558	22%	259	24%	258	22%
Horticulture	50	1%	50	1%	5	0%	8	1%
Hotel industry	504	7%	520	7%	70	7%	67	6%
Freelancers	500	7%	561	8%	65	6%	74	6%
Total	6,775	100%	7,224	100%	1,076	100%	1,156	100%

Data from VBD (2009a:54); own calculation.

GBs provide guarantees up to € 1m for loans to SMEs according to the binding definition of the European Union (EU).² Borrowers have to pay an initial flat fee of around 0.8% to 1.5% and an annual commission of around 1.0% to 1.5% on the volume of the loan. The interest rates have to be negotiated between bank and borrower. Generally, GBs cooperate with all commercial banks and also issue guarantees for silent partnerships via special venture capital companies (*Mittelstaendische Beteiligungsgesellschaften*) which are usually sister institutions with legal status of their own, and usually also refinanced by the KfW.

GBs are public-private partnerships. SMEs are represented within the scheme via their respective chambers and associations. In the Federal States of what was West Germany, chambers and associations are the main shareholders of GBs, along with the banks (public, cooperative and private). In the eastern

² To be considered as a SME, headcount must be below 250 and either turnover must be below € 50 m or balance sheet total inferior to € 43 m.

states, banks contribute more to equity than chambers and associations, which do not have as deep roots as in the West (Schiereck, 2002:184). On the public side, the Federation as well as the Federal States provide counter-guarantees of totalling 65% in the western states and 80% in the eastern ones, including Berlin, i.e. governments bear the largest part of the risk. Furthermore, governments provide subsidised loans, mostly via the KfW, to both SMEs and GBs.

Table 2 shows the distribution of the risk of default in a typical case: here the GB provides a guarantee of 80% to the commercial bank, and on the other hand receives a public counter-guarantee of 65% in the West and 80% in the East, including Berlin. In all Federal States, 60% of each counter-guarantee is provided by the Federation and 40% by the Federal State. It is shown that GBs are only partially liable for SME default risks, namely 28% in the West and a modest 16% in the East. However, their screening and monitoring functions tend to cover 80%, since the Federal States and the Federation rely on the GBs also for their shares.

Table 2
Typical distribution of the risk of default within the scheme
of Guarantee Banks (%)

Institution	Western Germany	Eastern Germany
Commercial Bank	20	20
Guarantee Bank	28	16
Federal State	21	26
Federation	31	38
Total	100	100

GBs are limited liability companies (*GmbH*), and formal credit institutions in the sense of §1 of the Banking Act (*Kreditwesengesetz*), GBs are audited by independent auditors, and regulated by the Federal Financial Supervisory Authority (*BaFin*). However, only in a very limited sense are GBs really “banks”, since they provide little financial intermediation. Their balance sheet structure and cash flow is rather similar to that of an insurance company, since their main liability item of the balance sheet is “provisions for risk” — in their case, for given guarantees. Unlike insurance companies, however, GBs show rather significant low-interest loans from KfW, which are basically invested in the capital markets so that the margin can be used to cover expenses.

For example, Berlin's GB has provisions of € 13 m, liabilities to banks of 24 m (which are basically the loans from KfW), and total assets of € 50 m at the end of 2008. With these numbers, Berlin's GB is one of the smallest financial institutions of the capital — even though it is not so young, being founded in 1991 after the re-unification of Berlin as a Federal State and emerging from several sector-specific credit guarantee societies (BBB, 2009).

Not in the balance sheet total, but important as an indicator of outreach, are the numbers and volumes of granted and outstanding guarantees of Berlin's GB. In 2008, around 2,000 guarantees were outstanding with a total volume of € 214 m which resulted in an average volume of € 108,000. During the year 2008, the GB provided 331 guarantees totalling € 44 m which resulted in an average guarantee volume of €133,000. These guarantees promoted a total of loans and silent capital of € 58m — which is rather modest for a sprawling city with around 3.5m inhabitants and a GDP of € 87.5 bn. In Berlin, there are around 113,000 enterprises (*Unternehmen*), including registered businessmen and businesswomen (*Eingetragener Kaufmann/Kauffrau*) paying value-added tax (Amt fuer Statistik Berlin-Brandenburg, 2008:389), which also means that they should have a bank account. Hence, only around 1.8% of these enterprises in Berlin are currently supported by the GB. Of course, not all SMEs require external financing, and many borrowers can provide sufficient collateral or have a very good rating which enables commercial banks to provide loans without GB guarantees. The savings bank of Berlin (*Berliner Sparkasse*) alone has about 52,200 “commercial clients” (Berliner Sparkasse, 2009:26), and furthermore, among its 2.3m “private clients” there are certainly a great number of formal and informal firm owners using their personal banking relations also for business purposes. All in all, the GB has a rather small outreach, even though the GB's potential niche is hard to estimate.

Besides outreach, the indicators costs, efficiency and financial sustainability are important as well. In 2008, the GB of Berlin reports that its surplus of fees, commissions and interest summed up to € 4.4 m. On the other hand, its administrative expenses were € 3.1 m. Furthermore, total payments on defaulted guarantees to commercial banks summed to € 6.4 m, of which the GB's share was only around € 1.4 m, since guarantees are usually counter-guaranteed by the State (own calculation with data from BBB, 2009). The administrative costs per guarantee of the GB and its sister institution which provides venture capital, calculated as the ratio of administrative expenses to number of the outstanding guarantees, was € 1,840 in 2008. This annual cost per guarantee represents almost 2% of the average outstanding guarantee of around € 108,000 which is more than the annual commission for the guaran-

tees. These numbers clarify that the GB does not achieve financial sustainability on its own and depends significantly on public support .

At the end of 2008, the outstanding total portfolio of all German GBs amounted to 44,192 by number and € 5.4 bn by value. During that year, the GBs altogether assigned 6,775 guarantees for loans and silent equity totalling € 1.1 bn. Consequently, the average volume of guarantees equalled € 157,000 — roughly € 20,000 higher than in Berlin. The total volume of loans and silent capital was larger and amounted to € 1.6 bn. The collateralised loan or equity in question being usually only one brick of financing, the total investments supported by GBs were estimated at € 3.4 bn according to the Association of German Guarantee Banks (VDB, 2009a:10).

Not only in Berlin, the German GBs show only a rather modest outreach. In comparison, the German savings banks alone had an outstanding credit volume of ca. € 631 bn to enterprises and private households in 2008 (DSGV, 2009:2).

In the same year of 2008, the total defaults of the system of GBs summed to € 109m which represented about 2% by value of the outstanding guarantees (VDB, 2009a:16). These payments were provided by the GBs to the commercial banks. However, as already mentioned, the largest part of these payments was borne by the Federation and the Federal States, because of the counter-guarantees of 65% in the West and 80% in the East.

With 43% by number of all guarantees, start-ups, enterprises whose formal foundation was up to three years ago, were at the forefront of the customers (VDB, 2009:11). Interviews have confirmed the impression that GBs are of special value for those young enterprises, which have great difficulties to come up with traditional collateral.

Decision-making and information system

As a first step, the SME normally applies for a loan at a commercial bank which can provide the loan on its own, with or without refinance through a KfW credit line, or it can refuse financing altogether. If the commercial bank applies for a guarantee, with the consent of the SME, the GB starts an assessment with its criteria of eligibility: for example, the potential borrower must be a SME, must not be in difficulty and furthermore, the SME must not have received too much State Aid — all that according to EU definitions. The volume of the guarantee must be below € 1 m, and the borrower must not have received the loan yet.

In a next step, the GB starts the screening process of the potential borrower. The process does not rely only on the commercial bank's documents but requires a set of its own. Furthermore, there usually must be an interview with the borrower, and a staff member of the GB visits the SME. In addition, the respective chamber or association is asked to send a reference. Instead of merely accepting or denying the proposal, the bank's loan officers and the GB staff often discuss the loan request with the prospective borrower. Indeed, that discussion can change the proposed financing structure and even the content of the investment project.

When the GB staff is in favour of providing the guarantee, it presents the project to its central decision-making body, the Guarantee Committee which, apart from the GB's staff members consists of (i) representatives of chambers and associations, (ii) representatives of commercial banks (public, private and cooperative) and finally (iii) representatives of the ministries of finance and economics of the respective Federal State that represent the Federation as well. This committee decides whether or not the GB will guarantee the loan. In spite of usually not being shareholders of GBs, the representatives of the ministries have the right to impose conditions and even to veto the guarantee, because, as already pointed out, the Federal States and the Federation normally provide a counter-guarantee. For the ministries, GBs thus assume valuable screening, pre-selection and monitoring functions as well as part of the risk so that not only big and medium-sized enterprises with their direct access to government agencies, can enjoy public guarantees but also small ones.

Once the loan is given, the commercial bank monitors the borrower. However, the GB also keeps an eye on the SME, since it receives the current financial statements. In the case of delay or default, the commercial bank has to inform the GB. The commercial bank and the GB can jointly negotiate a debt restructuring with the borrower. If that is not possible, the GB usually provides a first payment to the bank. On the other hand, the GB receives claims on existing collateral in the proportion of the provided guarantee (compare table 1). The commercial bank liquidates the existing collateral so that the exact value of loss becomes apparent. The commercial bank and the GB adjust their losses via a second payment. Usually, there is neither juridical action nor any other insolvency procedure, since the expected value of collateral does normally not justify formal insolvency procedures. Furthermore, enforcement against private persons with low economic means is usually not feasible. However, it is common practise to negotiate a realistic long-term loan repayment agreement with the defaulted borrower over the reduced amount.

The decision-making process shows that GBs are quite limited in their autonomy: only if public authorities and commercial banks cooperate can the GB become active and provide guarantees. Moreover, cooperation can be rather complicated due to high transaction costs such as time, discussion and documentation, on all sides. Furthermore, the banks are generally reluctant to let other institutions, such as the GB and public authorities, let alone competitors, monitor their core business, which provokes reservations among their loan officers. In the field study, a rather high degree of discretion and arbitrariness was discovered since there are banks and individual loan officers who almost never cooperate with GBs, while others do it quite often. There seem to exist long-term guarantor-bank relationships, especially on the level of loan officers, to reduce transaction costs and information asymmetries, and to create confidence. This alliance can be especially attractive for commercial banks when they want to finance start-ups or investments that change the firms significantly. Consequently, the GB and the commercial bank can shop for new clients together. After a successful start-up, the bank normally takes the enterprise into a long-term bank-borrower relationship making the GB redundant for that client.

Start-ups and new investments in existing enterprises are also attractive for the other main stakeholders: the representatives of the Federal State who want to stimulate growth and employment. Hence, a common ground might be found for all the partners involved.

To overcome their dependency on commercial banks, GBs have established the programme “Guarantee without Bank” (*Buergschaft ohne Bank*). In this case, the SME can first undergo the procedures of the GB, receives a guarantee, and then searches for a commercial bank. Furthermore, GBs can offer joint products with state owned development banks that provide soft loans which are usually attractive for SMEs.

Concerning information asymmetries causing credit rationing, GBs have a hard time to really augment the available information basis. In Germany, most commercial banks are universal banks and often provide relationship-banking (*Hausbank*). Hence, the commercial banks might know the SME, the owner, the manager and even the local employee families for a long time, and they have also monitored their saving and investment behaviour. However, such a relationship can lull attention and blind the eyes so that GBs providing a second due diligence and screening might throw a new light on a long-standing, unchecked *Hausbank* conviviality, because GBs are specialised in screening SMEs and their projects. Consequently, a trustful long-term guarantor-bank relationship can be quite attractive for commercial banks when it comes to monitoring declining enterprises with a long *Hausbank* history. In

some regions, commercial banks have few SME investment loan requests so that loan officers lack practice and are grateful for help (Kramer, 2008).

In general, GBs enable further learning effects on all sides. Chambers and associations have knowledge about markets that banks and borrowers might not have. Within the Guarantee Committee, the joint discussion of the SMEs' financial statements, the investment projects and the banks' financing enhances the information of the ministries of economics and finance. Consequently, this direct information on the needs of SMEs can improve local public policies. By augmenting the available information and reducing information asymmetries on all sides, the institutional set-up of GBs promotes and enables the provision of sound loans to SMEs.

On the other hand, not only high transaction costs, but also the distribution of sensitive information can put off potential participating persons and institutions, because the involvement of a third party in the triangle always means that internal information might spread to competing enterprises, banks or the tax authorities. That is why strict codes of professional conduct with regard to confidentiality and trust as well as institutional and IT firewalls are essential for a well functioning of probably every guarantee mechanisms.

A closer look at public support

Within the scheme of German GBs, there are basically four channels of public support without which the GBs would hardly be able to provide guarantees within their niche of riskier loans. However, subsidies by German government agencies can only be provided in accordance to the strict and sophisticated State Aid Regulations of the EU, and the details of national legislation which lie beyond the scope of this article.

As already pointed out, counter-guarantees are provided by the Federation (60% of counter-guarantee) and by the Federal States (40% of counter-guarantee), without charging any fee. In the western states the counter-guarantees equal 65% of the GBs' guarantees, in the Eastern ones 80%, thus reducing the GBs' and the commercial banks' risk exposure and the corresponding capital requirements of Basel I and II. However, counter-guarantees are not provided automatically. Any single counter-guarantee has to be accepted by the public authorities in the Guarantee Committee.

GBs are provided with public equity, since public commercial and development banks of the Federal States (*Landesbanken and Landesfoerderbanken*) and local saving banks are typical shareholders of these public-private part-

nership enterprises. Moreover, in Schleswig-Holstein the Federal State itself is a shareholder as well. This equity is not financially compensated. Unfortunately, GBs are not required to provide detailed information on the distribution of shares. Hence the exact distribution of participation, which varies between the various Federal States, cannot be provided here.

Furthermore, GBs hold the status of “common public interest” (*Gemeinnuetzigkeit*), which helps the institutions to receive tax relief. GBs pay neither corporate income tax (*Koerperschaftssteuer*) nor local business tax (*Gewerbesteuer*). This subsidy requires capital and profits to be used for additional guarantees for SMEs. However, this condition also implies that realised profits cannot be distributed among shareholders (Langer and Schiereck, 2002:45; Stefanovic, 2009:280). At first sight, this financial support looks like a growth incentive. However, the retention of profits also implies that shareholders have little financial interest in participating.

GBs received public KfW loans with low interest rates. In addition, the respective Federal State can provide more funding. The basic aim of this public support is not to refinance the operational activity of the GBs but to achieve interest spreads, since GBs can invest this cheap money in the capital market. Without this support, profit would not be possible (Kramer, 2008). When the association of GBs (*Verband Deutscher Buergschaftsbanken*) declares that the KfW loans have not been used since 2008, the reason for that lies probably in the extremely low interest rate levels so that positive interest rate spreads with relatively safe investments are almost impossible to achieve at the moment. In this crisis, the means of public support for GBs have changed, as will be presented in the next section.

Guarantee banks within the current crisis

Due to the present global financial and economic crisis, many policy makers have started public programmes to combat a possible credit crunch. In Europe, quite a few new credit guarantee schemes have been implemented, and existing schemes strengthened (EU, 2009:24; AECM, 2009). In Germany, too, existing schemes were bolstered, and an additional Federal guarantee package was decided on, amounting to € 75 bn. Among directly provided public guarantees, usually of higher volume, additional counter-guarantees to GBs were included too.

In October 2008, when many commercial banks fell into financial distress, the German GBs jointly declared that they did not feel any stress and

were not directly affected by the financial crisis. Furthermore, they declared that they were able and willing to confront and fight against a possible credit crunch for SMEs. Therefore, they lobbied for continuance of public support and for an easing of regulation requirements (VDB, 2008).

In December 2008, the European Commissioner of Competition adopted its “Temporary Community Framework for State Aid measures to support access to finance in the current financial and economic crisis”, which eased regulations on State Aid and provided a framework for national public initiatives until 2010. This enabled the German government, on the initiative of the ministry of Economics, to start augmenting public support for existing guarantee schemes in January 2009 (VDB, 2009a:9). The overall programme was approved astonishingly fast by the European Commission by the end of February 2009. However, in the case of GBs, many details of State Aid regulation were not approved until September 2009.

Most important is the increase of public support by the expansion of public counter-guarantees from 80% to 90% in the East and from 65% up to a maximum of 80% in the West. In addition, GBs are now able to provide guarantees up to € 2 m instead of € 1 m, and they can cover up to 90% of the loan. Consequently, the government can assume up to 81% of the outstanding risk, whereas the bank only assumes 10% and the GB 9% (AECM, 2009:10). However, GBs and the Federal States have also been forced to raise their expectations on future losses of outstanding guarantees due to the financial and economic crisis. The precarious aim is to prevent a credit crunch due to the financial crisis, but not to rescue all enterprises in difficulty.

Indeed, there has been a modest increase of provided guarantees in the last few months. In the period 1999-2008, annual approvals varied between 5,284 and 7,212 by number and between € 894m and € 1,132m by volume (VDB, 2009a). In the year 2009, not including December, GBs provided 5,913 guarantees that guaranteed a volume of loans and participations of € 1,400m (VDB, 2009b) — which would be a guarantee volume of around € 1,260m (assuming an average guarantee of 90%). However, a structural boost of activity through the crisis can not be seen.

4. Conclusions (or rather lessons learned)

Guarantee Banks of the German type are public-private partnerships. Due to specialization, an own screening process and cooperation with chambers and associations, they can reduce information asymmetries between banks

and SMEs enabling additional financing. Information is the main input from the side of the private sector, whereas the public authorities provide the necessary financial resources. In theory, that would be enough to give a positive judgement about the German GBs certifying a positive combination of public and private initiatives and interests. However, GBs have their limits and cannot fulfil too high expectations of policy makers. Even after decades of existence and substantial government support, they have not achieved considerable outreach.

Because German GB are not financially self-sustainable, depending on public aid and achieving little outreach to SMEs, policy makers in Development Finance should be sceptical about building similar institutions. The following lessons can be learned from the German GB experience.

Analysing the GBs' business niche, it has to be noted that GBs are sandwiched between credit and risk-sharing programmes of KfW and public guarantees for larger enterprises on the one side, and rather smooth bank-borrower *Hausbank* relations, also with support from KfW funds, for micro and small enterprises on the other. Within this limited space, performance depends largely on personalities who mostly find fruitful grounds in the segment of "subprime loans" that are too risky for the banks, such as start-ups and innovative investments, but at the same time politically promising enough to be counter-guaranteed by government agencies. Within the basic triangle, the typical GB-borrower relationship tends to be one-time assistance for overcoming the threshold to finance innovative investment or to face emergencies, whereas the GB-lender relationship tends to be more permanent, especially at the loan officer level. This long-term relationship reduces information asymmetries between bank and guarantor, reduces transaction costs, and augments confidence. Together, both institutions can jointly hunt new customers such as promising start-ups, which in many cases would not have obtained external finance otherwise.

With regard to start-ups and/or innovative projects, the "additional information" contribution which business associations and chambers are supposed to deliver to the guarantee system, is usually limited. Guilds and other "fraternal" associations know their long-standing members, but not the newcomers. In Schumpeter's (1987/1922) terms, they know the "wirt", i.e. the businessman or -women who is working along established lines, mostly with his or her own resources, but they do not know the "unternehmer", i.e. the entrepreneur whose innovation is financed by the banker, and whose success leads to "creative destruction" among the "wirte" — and to a corresponding latent tension between the two types of business persons. For example, a

representative of the guild-like local retailer association will hardly be inclined to cast a positive vote in favour of a guarantee for a new shopping mall investor. However, in times of crisis and recession, he or she could be the perfect source of information for the loan decision regarding established enterprises. In many cases, this famous “additional information”, could also be provided directly to the bank and/or the (counter-)guaranteeing government agency from the association in which the borrower is a member, without any formal responsibility from the association. Within the German public-private guarantee scheme of GBs, chambers and associations do provide some “additional information”, but in addition, they deliver a probably even more vital ingredient to the scheme, namely business culture, — which government agencies alone are hardly able to create.

The crucial problem of “ownership” should be kept in mind. Without any public support, purely commercial banks will probably always ration credit and will never be willing to provide sufficient finance for SMEs (see Stiglitz and Weiss, 1981 and the ensuing debates around that type of market failure). Public or publicly supported credit guarantee mechanisms can provide a way out of that trap. Thus in principle, the organised combination of private information and public money, as through the German GBs, makes sense. In an increasingly individualistic world, “fraternal” guilds and similar business associations are losing coherence and power so that guarantee schemes based exclusively on self-help are unlikely to survive, let alone emerge from scratch on a larger scale. However, being servant to so many masters within the augmented triangular relationship (figure 3) — *all* the local or regional private business associations and chambers, *all* the cooperative- public- and private banks and their associations, and *all* the public authorities — makes it difficult for the GBs to reach out into profitable fields, because those are occupied by one or the other of their shareholders. The governance structure also forbids the adoption of truly lean administrative procedures, because providing “additional information” is the GBs’ first core business, and screening almost the whole range of non-agricultural SMEs for public guarantees, be they direct or counter ones, is its second function — so that high transaction costs are there to stay. Most shareholders as well as the other external stakeholders have their particular reasons to keep the scheme small: for borrowers and SME associations it can be rational to prefer loans from banks without the GBs and their high transaction costs; also for commercial banks it can be rational to cooperate only in a few “doubtful cases” because of high transaction costs and information sharing with competing banks. Finally, representatives of government often tend to be restrictive since the government agencies, i.e.

ministries of economy and finance, have to pay the bill, and public budgets are directly affected, even if only in an uncertain future. Moreover, to avoid fiscal excesses and distortion of competition, regulation is imposed by the Federal States, the Federation and the European Union which retards the scheme's growth as well.

As a general conclusion, no institution of more than minimal importance can be everybody's darling, and in a market economy and a democratic political setting, any public-private partnership is bound to fail or remain of marginal weight and visibility, if it does not have a clear-cut vision for a successful performance of its top management. As a predominantly public agency, the political opposition and consequently the media would keep our loan guaranteeing institution under permanent observation, challenge and scrutiny. Alternatively, as a commercial private enterprise with a business spirit, the institution would be faced with competition from other rivals such as non-participating banking groups or business sectors and associations. Active owners will always try to direct their institution to flourish and grow at the expense of rivals, and to defend their enterprise against the loss of market shares and bankruptcy, or the loss of votes and political power. Consequently, the person in the driver's seat needs either the political mandate for leading a support agency, with concern for business interests as an important, but only secondary condition, or, the drive of the profit motive of an essentially commercial business entity, with political interests such as regional development and re-election as ultimately secondary goals. No dynamic spirit is likely to emerge without meaningful competition, be it political or commercial.

The appropriate institutional structure of such a public-private partnership remains an open question; the answer depends on the country's social structures and the banking system. The list of potential pitfalls to be avoided is long: Too limited a range of activities, too many masters, too broad a coverage with regard to competing businesses and banks, as well as not too costly conditions in terms of financial, administrative and transaction costs for all the participants. When banks, such as in Germany, are rather well informed about their customers because of traditional relationship-banking, and when SME borrowers are no longer integrated into corporatist local associations and chambers with a "fraternal" self-help mission, it makes sense that the third-party role in the basic triangle is predominantly played by government. However, when the opposite is true — no proper banking service for SMEs, but rather active self-help associations, and no willingness of the government to assume refinancing and loan guaranteeing functions in a direct way — the public-private partnership model of the German GBs could turn out to be re-

plicable, — however, with business clearly in the driver's seat, more room to manoeuvre, and less government influence and subsidies.

Summing up, the privately organised German Guarantee Banks lack financial sustainability and hence depend on ongoing public financial support. Furthermore, they do not achieve a notable outreach within the German Financial System. However, GBs provide a valuable service to their limited group of clients, and they enable the government to channel public guarantees to small businesses in a rather fair and non-discriminatory way, and to learn about their problems. How then to weigh costs and benefits of institutions like GBs? Our tools as economists are quite elaborate, but they are usually oblivious to uncertainty, they are based on numbers and thus unable to unravel the probabilities of identifying exactly the missing qualitative links between the innovative entrepreneur and his or her financiers, banks and guarantors. Guarantees for one or two successful start-ups like Bill Gates could easily justify any institutional set-up, — but would be hard to identify *ex ante*. Our rather critical assessment of the German GBs should therefore not be taken as a final verdict but rather as a modest academic exercise in institutional scrutiny and as a warning against too euphoric loan guarantee initiatives.

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