Financial Institutions and Services

The Role of the Funding System and Guarantee Credits Destined to Small Entrepreneurs in the Current Context -I

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Abstract: Financing schemes do not limit only to covering the financing needs from their own funds or raised ones. Their role should insure that the economic development is impelled, ensuring the necessary funds, as a whole, but especially at the level of small entrepreneurs, much more exposed to the turmoil of the contemporary economy. At EU level it is recognized the important contribution that the SMEs bring to the economic development and growth, as they are creators of employment opportunities and key factors of local and regional prosperity. But the funding needs are increasingly higher and the access to financing is more difficult, mainly due to the lack, insufficient or limited availability of guarantees. In this context, the guarantee funds represent a solution, proven by the European economies and recently launched in Romania. Guarantees as financial instrument to develop and stimulate the entrepreneur are issued by specialized organisms, respectively by banks or guarantee founds. Guarantee founds are an active part in European business environment. The analysis in this paper is based on the study of official documents, reports of specialized bodies, statistics and examples of good practice, summarized and interpreted in comparison and in developments. The aim is identifying a series of issues that can lead to the influence of responsible factors – the public authorities, credit institutions, professionals – in order to come up with new practical solutions that would induce the guaranteeing process qualitative factors and to stimulate the financing process of small entrepreneurs.

Keywords: guarantee funds; SMEs; European practices; financial supervision

1. Introduction

World financial-banking phenomenon is manifested by a set of markets, techniques and tools that offer to investors a wide range of products and they facilitate the profits, but it also multiplies the risks, with rapid dissemination. Financial-banking system's role is not limited only to cover financing needs of the temporarily available funds. It should seek to boost economic development, ensuring the necessary funds but at the level of big companies and small entrepreneurs, more

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exposed to the turmoil and dynamic phenomena context in the contemporary economy. Moreover, if the necessary investments in a particular period or in a disadvantaged area (emerging economies, economies affected by financial crisis, etc.) are massive, then the savings that need to be financed are totally insufficient or they shift, because the offered output does not cover the risk. The role of financial of monetary intermediaries becomes predominant and it leads to a system known as “debt economy” of entrepreneurs to banks and banks to the central bank. In the debt savings the risk relates to financing companies, and in the case of implications arising from unforeseen circumstances, the risk is borne by the state, the central bank providing liquidity to banks in difficulty in order to prevent the risk of system. (Corduneanu, 1998) The effects are reflected directly or indirectly on the economy, either by cost (interest, risk premiums, excessive taxation, etc.) or by limiting funding and the offered guarantees lose some of their value and credibility. The economy has more to suffer, mainly the small and medium businesses that lose all chance of funding.

In this respect, it supports the idea of a need for the reform of financial intermediaries or to find alternatives, so as to achieve a more effective financing of economic development. There is unprecedented innovation and the diversification in products and financial services, and also of the bodies that manage them.

The current global crisis has absolutely affected all areas of activity – we are talking of food, energy, climate, financial, economic and social crisis - and a direct consequence represents a more difficult access to funding and fewer foreign investments. The financial and economic crisis triggered in 2007 produces the most dramatic effects, even greater in the emerging and developing countries, especially in those where there is the lowest income.[1] Insufficient capital was the most frequently cited reason for entrepreneurial failure in both the transition region and the Western comparators, and even more so in the transition countries. And the underdeveloped financial systems of the country are considered one of the possible causes, along with de Bureaucratic impediments.[2]

2. Context, Developments, Concepts and Approaches

The materialized market deficits in high dependence on the bank credit, accompanied by the limitation and cost of credit, the high level demands of guarantees, the negative reactions towards risk and low interest towards small projects, insufficient solvency and liquidity, the lack of funding in the initial stages

[1] European Parliament, Committee on Development, Report on the financial crisis and economic crisis on developing countries and on development cooperation (procedure 2009/2150 (INI), March 9, 2010.
[2] http://www.ebrd.com/downloads/research/transition/tr11.pdf , Transition Report 2011 al EBRD

and of concepts relating to capital are just some of the real problems faced by the economic agents in our times, in Europe and Romania.

The financial crisis was transmitted mainly through financial channels. In addition, financial integration seems to have fuelled the credit boom preceding the financial crisis. This credit boom and the related stocks of private foreign debt are widely believed to have made the transition region so vulnerable to the financial crisis, and are in fact strongly correlated with extent to which output declined in the region during the Crisis. (Berglöf, Korniyenko, Plekhanov, & Zettelmeyer, 2009)

In Romania, financing was maintained mostly through bank loan, and the risk of a credit crisis it manifests dangerously; credit is the major investment of banks, while other forms of investment are reduced, motivated by a still symbolic representation of the debt securities and specific markets.

In this context, a real use for business environment represents the innovation of guarantees. On this level, the credit guarantee organizations have emerged as a result of the association of small entrepreneurs in an attempt to find solutions to difficult access to financing, a situation exacerbated under the crisis conditions.

In most cases, this phenomenon has been reinforced by the government intervention, that was very aware of the important role played by SMEs in the national economies, by the important contribution to the economic development and growth.

At the EU level it is recognized more explicitly the role of SMEs, "as creators of employment opportunities and key players in the prosperity of local and regional collectivities. Dynamic SMEs will strengthen Europe to the uncertainty caused by the current globalization".[1]

Guarantees as a financial instrument for development and stimulation of entrepreneurship, are issued through specialized bodies, namely banks and guarantee funds. Banks or guarantee funds have as activity also guaranteeing loans and other financial instruments which may be obtained by economic agents.

Although we have not identified an overarching definition, in practice the credit guarantee funds are bank and non-bank financial institutions whose role is to undertake the credit risk of credit entities, by guaranteeing to a portion of debt service of a debtor in the case of the failure of its payment.

[1] Commission of the European Communities, Communication from the Commission to the Council, The European Parliament, The European Economic and Social Committee and the Committee of the Regions, Brussels, 25.6.2008, COM (2008) 394 final, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2008:0394:FIN:EN:PDF

For the acceptance of the International Monetary Fund[1], guarantee funds are institutions that provide customers against losses that affect the financial companies or that can be generated from certain contracts. The mission of the guarantee funds refers to: risk sharing between the lender and the fund; targeting a segment of specific activity; supporting some viable and of impact projects.

Credit Guarantee Funds represent instruments of stimulating investments for small and medium enterprises (SMEs) by partial taking over the risks that the credit institutions are facing. At the same time, they represent a form of protection against very high risks, which involves the lending of SMEs, particularly in medium and long term.[2]

The origin of mutual guarantee coincided with the emergence of organizations in France "Societes de Caution Mutuelle/Societies of Mutual Caution", established under a law in 1917. Since 1929, similar societies have developed in Belgium as well. Later in the reconstruction process of Europe after World War II, the system developed in Germany and Italy, although the evolutions were different. Thus, in Germany, these associations have developed rapidly, being supported by the state, while in Italy, they have known a real development triggered only after the oil crisis in 1973. In Spain, these companies have emerged as an economic policy instrument and as a means of promoting the industry since 1977, in the context of the transition beginning towards a democratic society.

Currently, the mutual guarantee societies in Europe present a great heterogeneity.

It may be noticed the existence of regional organizations of guarantee, among which the European *Association of Mutual Guarantee* (AECM), founded in 1992, an international, democratic, open, independent, non-profit organization having its headquarters in Brussels, whose members are part of the guarantee private sector, as well as the public one. The AECM carry out lobbying activities at EU's level in support of Guarantee Bodies. From the volume of European guarantees, the AECM accounts for about 10%. In accordance with its constitutive act, the AECM's main objectives are: strengthening and developing the role of guarantee and, in particular the mutual guarantee, as a financial instrument to facilitate the SME access to financing; to stimulate the exchange of information and know-how between members; promoting and harmonizing the legal guarantee of schemes and communicating ideas, of proposals submitted to the Party involved in economic policies, including the EU. In 2009, the AECM member organizations had a portfolio of guarantee total 70.4 billion Euros and issued a total of 34 billion Euros

[1] IMF, Monetary and Financial Statistics Manual, 2000; http://www.bnro.ro/

[2] http://garantinvest.md/pdf.ro.pdf, Financial guarantee an efficient instrument of entrepreneurial development, 2006

in new guarantees.[1] All credit guarantee funds in Romania, including counter-guarantee fund are members of AECM.

The European guarantee agencies are established and supported by the public institutions or they operate as nonprofit organizations with sole purpose of supporting private initiative and / or public by compensating the lack of guarantees towards banks, based on the national counter guarantees and / or supranational ones offered and funded by the European Commission.

The guarantee system works either by guaranteeing a percentage share of the total credit also without exceeding a certain level, or by establishing a coverage guarantee, in absolute terms, the a relatively small nominal value, which gives a dispersion of risks and discourages big firms.

The KBN - European Business and Innovation Centre Network considers the following elements as being essential to the success of credit guarantee funds: sufficient initial capital and careful financial management; detailed and rigorous defining of acceptable risk level; the capacity of risk assessment; high degree of independence; segmentation of different types of accepted risk, appropriate monthly risk tracking; close cooperation and regular communication with banks; investment guarantee level limited to a maximum of 75%; participation to financing from the debtor's part.[2]

The International classification of guarantee systems based on the fact that there are two general models of guarantee: 1. *Guarantee companies* (mutual guarantee companies, Guarantee Companies) 2. Guarantee programs (specialized institutions guarantee, institutions run by public administration bodies)

Table 1. Specific compared issues between guarantee companies and programs[3]

Indicator	**Guarantee Societies** *(Romania - FRGC, FGCR)*		**Guarantee** ***Programs*** *(Romania - FNGCIMM)*
	Societies	**Mutual Societies**	
Decision on creation and origin	Social agreement	Social agreement	Government/Administration
Legal scope	Private	Private	Public
Legal personality	Legal societies	Specific legal societies	Public and in developing banks, developing agencies, public entities, specific funds for covering

[1] http://infoportal.rtv.net/articol~din-economie~info-2259621~investitii-garantii-reusita.html
[2] http://infoportal.rtv.net/articol~din-economie~info-2259621~investitii-garantii-reusita.html
[3] Fundación ETEA para el Desarrollo y la Cooperación, Pablo Pombo González, Horacio Molina Sánchez, Jesús N. Ramírez Sobrino, María José Vázquez de Francisco The European Framework of Guarantee Systems/Schemes: Main Characteristics and Concepts, Working Paper, July 2006; http://garantinvest.md/pdf.ro.pdf, personal processing of data.

Indicator	**Guarantee** *(Romania -*	**Societies** *FRGC, FGCR)*	**Guarantee *Programs*** *(Romania - FNGCIMM)*
	Societies	**Mutual Societies**	
Decision on creation and origin	Social agreement	Social agreement	Government/Administration
			risks.
Capitalization	Corporate capital	Corporate capital	Budgetary resources
Origin of resources	Mixed: pub. and/or priv.	Mixed: mostly priv.	Public
Situation and evolution of resources	Increases with activity	Increases with activity	Limited
Temporality of resources	Non-Temporary	Non-Temporary	Temporary
Participation in management by micro and SME's	No / Yes	Yes	NO
Supervision Regulation (call for capital, provisions)	Yes	Yes	According to institution
Corporate purpose/exclusivity of the guarantee activity	Guarantee exclusive	Guarantee exclusive	Issuance of guarantee for SMEs together with other activities (in the case of public bodies the guarantee activity may be exclusive)
The purpose of the activity	Profitability	Aid members	Aid members

For guarantee companies there is a clear distinction between guarantee companies whose activity seeks a profit and mutual guarantee companies, where the goal of helping the members has paramount importance. Although both meet the specific legislation, there is a major distinction between them, which can occur even in the name of guaranteeing entity.

In the case of guarantee programs, there is a major difference depending on how the guarantee activity is conducted. Thus in some cases there are specialized public institutions, which carry out self guarantee management, while in other cases, the guarantee management is held directly by the bodies / departments of public administration.

Joint actions on the direction of supporting the development of small entrepreneurs find more and more partners at European level. Thus, South East Europe is directly approached for the development of an environment appropriate for innovative entrepreneurship, by the Network project which starts from a core group of already existing cooperation partners addressing innovation and technology support to micro, small and medium sized companies (MSME) having as starting point the credit guarantee organizations.[1] It identifies the current policy issues of credit guarantee development in Eastern Europe and recommends how governments can address specific actions in order to improve the environment particularly for small and medium-sized enterprises. The main goals are the creation of a technological platform as a common language in the credit organization tools which collects SMEs information in the same way as in the Europe; Creation of common standards and operative methodologies among different credit guarantee schemes in order to foster cooperation among SMEs and promote their development and internationalization.

Including the European Court of Auditors, in the Special Report no 4/2011 "The Audit of the Guarantee Fund for SMEs", shows that the access to credit represents a problem for SMEs in Europe. Based on its findings, the Court has made a number of recommendations, such as, in the future, the Commission would establish more measurable specific target levels in order to achieve the objective of facilitating the monitoring the achievement of the financial objectives' instrument. It also states that there should be provided adequate measures in order to ensure a more effective allocation of EU funds in favor of those SMEs that have viable projects, but if there was no such instrument, it would have not been able to obtain financing.[2]

3. Aspects on Good Practice from the European Space

In the methodological approach, we investigated several models of practice in Europe, models that we present below.

In *Germany*, for example, there is a system with regional companies, with multi-sectorial feature, present in all provinces, with non-profit status and ownership among the financial institutions, of insurance banks and Chambers of Commerce and a partnership at national level. This organization gives them independence, flexibility in decision making and risk taking. There are relationships with banking system and they are commercial partners of the state, supporting its programs, including social directions, such as creating new jobs. In the German model it predominates however the guarantees for creating new companies.

The Guarantee companies have a double purpose: the development of SMEs by facilitating credits guarantee; "to sensitize" the commercial banks to grant small credits by optimizing the capital requirements, costs and provisions.

The counter-guarantee, recognized by competent authorities as subsidy, is provided by the State and Federal Government, so that risk sharing takes place in chain.

[1] http://www.cadses.net/ , GO Network – Guarantee Organizations Network

[2] European Court of Auditors, The Audit of the SME Guarantee Facility, Special Report no 4, 2011, http://eca.europa.eu/portal/pls/portal/docs/1/7932726.PDF

In *Spain*, the regional structure prevails, with a tendency, however, towards one company per region. Some sectorial organizations also operate.

In *Austria*, the national guarantee mechanism has a direct coverage by the state. The activity is provided by limited liability companies that have a similar status to that of a bank and it deals with, under a special law, by the guarantee of private investors (individuals, companies, institutional investors, SMEs). Without specific agreements, it collaborates with all commercial banks and it supports private investors offering consultancy, training and tools to guarantee specific life cycles of companies, for credits and participants on the capital market. It supports investors including business internationalization, ensuring 50-100% of the value of the credit, but with a limit of amount.

In *France*, it has been developed a model based on the coexistence of two companies' networks: one is the Multi-professional type (SOCAMA companies) and the other is a national network of sector type.

In *Italy*, the guarantee scheme for SMEs is provided by mutual guarantee companies (private companies whose shareholders are the SMEs) and national and regional funds for counter and direct guarantee (public sector). Thus it is achieved a double cover: a sectorial and geographical one. Mutual guarantee companies are specialized on activity sectors (crafts, industry, trade and tourism, agriculture activities) and it supports the SMEs which are members in accessing credits, on more favorable terms regarding the costs and size, based on the agreements with commercial banks. On this basic structure, it is overlapping a broad range of networks of unions and associations operating in the regional context ("regional regruppaments") and two federal structures at national level, one in the industry domain and another in trade.

If in Belgium it prevails the short-term guarantees, in Italy there is a variety of entities specialized in long term transactions.

The State intervenes in supporting the guarantee institutions by different means[1]: promoting legislation in this respect, often targeting their creation as well; monitoring and control of guarantee systems operation; tax incentives; capital contributions, nonrefundable aids directly provided to guarantee funds, reinsurance and share of risks and losses of these companies. Thus, in Germany, the credit guarantee companies, defined as the banking law, are exempted by a series of taxes, including income tax. In Spain, the guarantee companies pay tax at a lower level compared to other companies, being all together exempted by other taxes. In France, the credit guarantee companies pay income tax, but they are exempted from taxes for risk provisions set on medium and long term. In Italy, the credit guarantee organizations are exempted from taxes on reinvested profit.

[1] http://garantinvest.md/pdf.ro.pdf.

In Bulgaria it stands the USAID Guarantee mechanism by which the Loans Development Authority (IDA) provides guarantees to municipalities as debtors of the United Bulgarian Bank, which guarantees 50% of loans. A total of 13 municipalities have turned to this tool so far. In Macedonia there are similar mechanisms as in Bulgaria.[1]

4. Prudential Approach at the Level of the European Community

The European officials, that the European Commission have signaled the more extensive presence in the market of financial product and services of the so-called parallel sector banking or "shadow banking", with the importance of non-bank lending functions that create new sources of funding.[2] Possible entities included in this system are: financial companies and firms of real-estate values that provide credit or *credit guarantees* or make changes in liquidity and / or date of payment without being regulated as banks - insurance and reinsurance companies issuing or *guaranteeing credit products*; money market funds (MMF) and other investment funds; special purpose entities engaged in liquidity transformation and / or date of payment, etc.

Financial Stability Board (FSB) estimated the size at the global level of the parallel banking system to about 46 000 billion EURO in 2010, increased compared to the 2002 value of 21 000 billion EURO. This value is 25-30% of total financial system assets and half the bank. At the international level, the share of assets held by European jurisdictions increased from 10 to 13% for intermediaries in the UK, from 6-8% for the Netherlands, from 4-5% for intermediaries in Germany and the 2-3% for those in Spain. Intermediaries in France and Italy maintained their previous share of assets held in the parallel banking system to the international banking system, that is 6% and 2% respectively.

The parallel baking activities can form a useful segment in the financial system that is: it offers investors alternative to bank deposits; it channels resources to specific needs in a more efficient way, because of their more specialized degree; it represents alternative sources of financing for the real economy; it is a potential source of diversification of risk outside the banking system.

On the other hand, this important financial area, which includes the guarantee companies, is concerned in terms of prudential regulation and supervision, given the potential risks to financial stability in the long term, of systemic nature. At the microeconomic level, a low degree of regulation and supervision of this sector

[1] Guide loans to local government and the situation in the countries represented in NALAS, http://www.acor.ro/documente/materiale_proiecte/ghid%20ro.pdf

[2] 52012DC0102, CARTE VERDE SISTEMUL BANCAR PARALEL/*COM/2012/0102 final*/, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2012:0102:FIN:RO:HTML

compared to the rest of the financial sector it may cause the migration of a considerable segment of the traditional banking in the parallel system.

In response to the calls that have been addressed within the G20 in Seoul in 2010 and at Cannes in 2011, the FSB deals currently with developing recommendations on the supervision and regulation of this activity. The stated objective is that of responding proactively and to ensure that all financial activities contribute to the economic growth.

In this context, we mention the regulatory proposals of the European Parliament and Council on the prudential requirements for credit institutions and investment companies,[1] approved by the Economic and Social Committee[2], which can be considered including the parallel banking sector, i.e. the entities of credit guarantee.

In terms of micro-prudential, the new framework requires a larger capital and of better quality, larger and diversified reserves of capital, better risk coverage, introducing a minimum rate of leverage (3%) as a means of protection against risk-based regime and a new approach in terms of liquidity.

4. Conclusions

The international classification of guarantee systems identifies two general guarantee models that is: the guarantee companies, which can be mutual guarantee companies and guarantee firms, each with its specificity; guarantee programs, the second basic component, which can be the specialized institutions or institutions run by guarantee public administration bodies. This classification cannot be rigorously correct and applied in the current reality. In many cases, the two models coexist as a result of a model specific to each country and the historical evolution of guarantee activity or it is the interplay between models and subdivisions.

In Europe, guarantee credits have a number of common lines, including: specialized bodies provide consultancy, training and guarantee instruments; the main purpose is to support the development of SMEs by facilitating the credit guarantee and sensitize the commercial banks to grant credits; the State is an active presence by supporting the guarantee institutions through various means, directly or indirectly.

The development of guarantee funds has become a necessity; the European responsible people provide strategic guidance, and the national governments are directly involved, being aware that these financial institutions could solve several problems that the small and medium enterprises are facing. The funds grant

[1] COM(2011) 452 final – 2011/0202 (COD)
[2] 2012/C 68/07.

guarantees where there are not sufficient and take from the risks and the monitoring costs. In addition, the guarantee funds can offer professional assessment of projects and consultancy for financial management of SMEs.

One of the directions of action is hiring specialized banks, guarantee funds or companies of insurance / reinsurance in credit risk taking, with their recognition by the authorities.

The need of involving third specialized parties in guarantee and counter-guarantee is supported by the complexity, turbulence and dynamics of the phenomena from the contemporary financial and banking market.

Guarantee entities are included by the European officials in the so-called *parallel banking sector*, with bounded with important contributions to the financial activity worldwide, but as well with the risk to financial stability. In this context, the proposals for regulation at European level, on prudential requirements for credit institutions and investment companies must be analyzed los from the perspective of the results of credit guarantee funds, so as to achieve a greater coverage in monitoring the financial risks.

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