Debt and risk sharing schemes

Debt and risk sharing schemes aim to reduce the risk for lenders/ investors in order to facilitate access to external finance for innovative firms. They include government subsidized loans and credit guarantees.

Credit guarantee schemes can facilitate access to finance for firms with a higher risk profile by limiting the loss that a bank faces if the firm defaults. They can help address lack of access to finance for young innovative firms that lack collateral and/or credit histories to gain access to capital. Governments typically partially insure banks losses on the loans covered by the guarantee, but leave it to banks to decide which loans to give, taking, thereby, advantage of their credit assessment expertise.

However, credit guarantee schemes raise several challenges. They need to be designed carefully to minimize potential misalignments of incentives, since otherwise they can incentivize banks to be less careful when selecting what companies to fund. While funding higher-risk loans may be the intended aim of the policy, governments sometimes have little control on whether the “wrong type” of risky companies is being selected (i.e., low productivity firms close to bankruptcy rather than risky innovative firms), as well as on the level of effort banks put into monitoring them (and collecting in case of financial distress). A higher share of the loan guaranteed by public institutions might allow more constrained borrowers who lack collateral to get more external financing, but it might have a negative impact on lenders’ screening and monitoring efforts. As a result, credit loan guarantees may increase the number of borrowers who receive finance, but may also raise the bankruptcy rate among those who did not receive the guarantee, both because of greater adverse selection and moral hazard.

Evidence on the effectiveness of these widely used programmes is scarce and mixed. Evaluations have mainly focused on “additionality”, that is, the extent to which the programmes have benefited firms that would not otherwise have been able to obtain loans, and on the level of default.

Alternatively, public policy can support debt financing by providing direct lending provision through a government-owned bank. This provides greater control than credit guarantee schemes. However, insufficient expertise, soft budget constraints and political objectives can lead to poor credit cultures without sufficient discipline, and substantial administrative costs.

References

- OECD (2011), Business Innovation Policies: Selected Country Comparisons, OECD Publishing. http://dx.doi.org/10.1787/9789264115668-en [1]

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