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Executive Summary

State Guarantee Restriction

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The Program awards annual fellowships to outstanding Israeli graduate students. We train and deploy some of Israel's best and brightest young professionals to create pragmatic financing and economic policy solutions.. Our applied research and Financial Innovations Labs® are a launching pad for transformative change, using innovative financing mechanisms, programs and policies to bridge social, regional, economic and productivity gaps within Israel and between Israel and the world.

In addition, Fellows craft their own projects during their internship aimed at barriers to job creation and capital formation in Israel. The Fellows' research, carried out under the guidance of an experienced academic and professional staff, support business and policy makers to shape economic reality in Israel. The program offers the ultimate training opportunity, combining real-life work experience with applied research.

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Fellows Program alumni can be found in senior positions in the public and private sectors. Some serve in key positions in government ministries while others work at private-sector companies or go on to advanced graduates studies at leading universities in Israel, the United States and Great Britain.

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Background

A state guarantee is a type of contingent liability in which the state protects a creditor in the event a debtor becomes insolvent or unable to pay its debt. On the one hand, state guarantees carry zero up-front cost and sometimes no cost at all. Furthermore, they address market failures in areas of governmental interest, particularly by reducing financing costs for two major engines of growth: small and medium businesses and supporting local exporters. On the other hand, excessive use of state guarantees can be greatly burdensome since it is impossible for the state to accurately predict when and how much the state will need to pay. The result is a lower national credit rating which in turn makes it more challenging for the state to raise debt. This outcome was observed in several European countries following the 2008 financial crisis.

Defining the problem

Recognizing both the necessity and challenge of state guarantees, it is necessary to create a restriction mechanism to avoid irresponsible use of guarantees and to manage risk and minimize potential damage during a financial crisis.

Today, the Accountant General's Department, responsible for providing state guarantees and portfolio risk management, is limited in its ability to issue state guarantees by byclause 3(b) of the "State Guarantees Law" (1958), which stipulates state guarantees should not rise above 10% of the state budget, excluding the budget for development.

This paper aims to provide the first analysis of various aspects of the clause, such as how high the limit should be, and whether or not it should be linked to the size of the budget. The objective is to establish whether or not the clause enables the state ability to carry out its policies and support sectors stymied by market failures, without interfering with the financial stability of the state by assuming excessive contingent liabilities and raising uncertainty as to the fulfillment of government debt.

The use of state guarantees in Israel

In recent years, there have been three main recipients of state guarantees in Israel: Israeli exporters who receive a guarantee against foreign trade risks, The Israel Electric Corporation, and the fund for loans to small and medium enterprises (SMEs) guaranteed by the state. The volume of guarantees has naturally increased in the years following the financial crisis, and currently stands (as of May 2015) at approximately NIS 16 billion.

If we examine the scope of guarantees over the years in relation to their legal limit, we find that in the past five years the amount of state guarantees falls around NIS 8 billion short of the 10% of the budget restriction. This might lead to the conclusion that the limitation rule is entirely ineffective;

however, the Accountant General's department decided to set aside a reserve fund for use in the event of the unexpected collapse of a vital entity that would signify a significant chunk of the working plan portfolio being taken "out of the game". In addition, there are several initiatives to carry out new programs in the future that may result in a further extension of exposure that can be covered by the reserve fund.

Israel in comparison to the world

This study is a comparative perspective international survey of the extent of the use of state guarantees and their mechanisms of restriction. It is important to note that the ability to make a valid comparison of the volume of use of guarantees internationally is challenging and incomplete, due to the fact that there are significant discrepancies in the definitions, reporting requirements, and the accounting treatments of different countries. Furthermore, there is difficulty in performing a comparison that describes the policy regarding the use of guarantees between Israel and EU countries, because since 2008 many of the EU countries were forced to issue guarantees to rescue banks and other EU member states from bankruptcy.

Nevertheless, the survey shows that Israel has a considerably stricter and more conservative mechanism for restriction and therefore uses state guarantees significantly less than most European countries. More, most countries included in the research have adopted a policy of reducing the provision of guarantees in which quotas are set for specific programs but have not adopted general restrictions on the total volume.

Recommendations

This research concludes by formulating three main recommendations that will hopefully serve as the basis for expansion into a future policy report, the goal of which will be to determine the correct limitations considering the characteristics of the Israeli economy:

1. Opportunities and risks in raising the restriction’s ceiling - The State of Israel is more conservative in issuing guarantees than EU countries. Further, it is clear that the current maximum cap on guarantees is ineffective, even considering the vital entity reserve discussed above. In light of this, raising the ceiling of limitation might be wise. At the same time, it must be taken into account that credit agencies might react to a raise in the limitation ceiling by downgrading the credit rating, which would harm Israel's ability to raise the sovereign debt.
2. The linkage between the cap and the budget - There is no economic logic behind this linkage. Guarantee schemes are generally divided into cyclical and anti-cyclical measures, and as such the size of the budget does not reflect the scope of guarantees required. Thus, it

is necessary to identify macroeconomic and financial parameters that better reflect the dynamic need for guarantees.

3. A sub-limitation of guarantees with a single borrower – The international survey indicates that it is customary to impose quotas upon certain types of guarantees. In the view of this report, state guarantees that create exposure to a single borrower are exposed to more risk and create a greater moral hazard. A sub-limitation which would reduce such exposures should be examined.

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