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AN ASSESSMENT OF THE GOVERNMENT LOAN FUND FOR SMALL AND MEDIUM SIZED BUSINESSES IN ISRAEL

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KORET FOUNDATION | MILKEN INSTITUTE

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An Assessment of the Government Loan Fund for Small and Medium Sized Businesses in Israel

Noa Parag

Introduction

Most developed countries, and quite a few developing ones, have come to realize the importance of the small-and medium-sized business sector in enhancing market competition, encouraging modernization, increasing employment (especially within weak sectors) and growing the economy. This realization is expressed in extensive government assistance programs aimed at the small and medium business sector and includes tax relief, financial aid, and technical and managerial assistance. One of the more prevalent financial tools employed to assist the small and medium business sectors are government sponsored loan guarantee funds, which guarantees a portion of commercial loans to small businesses.

In September 2003, the Israeli government's Fund for Promoting Small Business began to grant a state guarantee of 70% for loans to small businesses. In addition to this fund, an additional state fund assists new immigrants – the Business Fund for Self-Employed Immigrants, and a number of private funds throughout the country assist small business.[1] One of these funds is the Koret Israel Economic Development Funds ("KIEDF"), which was founded in 1994 with philanthropic funding.[2] KIEDF works together with the Bank Otsar Hachayal and provides an average guarantee of 35% for qualifying commercial loans to small businesses. KIEDF is the dominant private fund facilitating credit to the small business sector in Israel, and operates as a revolving loan fund; the new government fund is modeled in many respects on the KIEDF program (see: Ministry of Industry and Trade Press Release of Minister Ehud Olmert, July 2003, at www.kiedf.org). In evaluating the operation of the state fund and its costs, comparisons between the two can be instructive

State Financial Assistance to Small Businesses

In 1993 the first Israeli government loan fund for small business was established[3] to supply credit and assist in establishing or expanding small businesses in all sectors of the economy.[4] The fund was operated by a number of commercial banks and managed by a Steering Committee. In the 4th quarter of 1997 the banks curtailed their involvement in the fund for three main reasons: (1) approximately 29% of the borrowers were in default[5]; (2) cooperation between the banks and the coordinating body overseeing the fund was problematic[6]; and (3) the demands made by the Ministry of Finance in order to draw the government guarantee on defaulting loans made it difficult for the banks to actually collect,[7] causing substantial losses to the banks, to the entrepreneurs and in retrospect, to the state.

In November 2001, the Steering Committee decided to create a Fund for Working Capital, with a budget of NIS 100 million (approx. $22 million).[8] The purpose was to renew state loan guarantees in order to assist small businesses with financing difficulties, primarily occasioned by the Intifada. But because the criteria for granting assistance were too stringent, few businesses succeeded in obtaining loans, and it ceased operations after only 13 months.

In September 2003, the government tried again and the Fund for Promoting Small Business was launched. The fund's stated purpose is to assist small businesses with cash flow difficulties, to establish new small businesses and to expand existing ones by increasing the supply of credit. The state guarantees 70% of the total loan amount. Participating banks are allowed to require collateral from the borrower for the remaining 30% of the total amount of the loan.[9]

The present state fund is a budgeted fund, as opposed to the previous funds established by the government, which were only guarantees. This time the guarantee funds are actually deposited with the participating bank. These deposits earn interest and are index linked; previously, the money was transferred to a bank only in the event of a default by the borrower, and as noted, the ministry made calling the guarantees a difficult process.

The state earmarked NIS 100 million for deposit with participating banks and funds so deposited by the state leverage credit extended by the banks at a ratio of 1:6.25. For every shekel deposited by the state, the banks have agreed to extend 6.25 shekels in credit to small business. Regardless of the total losses incurred by the banks, the state's loss exposure may not exceed the deposit. The banks charge an interest rate of up to Prime + 2.9% on fund loans.

The government issued a tender for a company to coordinate the loan fund that was won by Tavor Economic Consultants Ltd.[10] Loans are granted after execution of a financial and business assessment of the potential borrower by Tavor, a financial assessment by the bank, and final approval by a Credit Committee comprising representatives of the banks, the public and Tavor. As of December 2005, the fund had approved 1,524 loans for NIS 450 million.

As of June 2006, the state had deposited NIS 90 million of the 100 million earmarked for the fund; NIS 50 million with the Bank Otsar Hachayal, NIS 31.5 million with the First International Bank of Israel, NIS 6 million with the Mercantile Discount Bank (designated for the Israeli-Arab sector), and a one-time NIS 2.5 million payment was made to Tavor for expenses. In addition to this payment, Tavor's annual budget – which is not drawn from the earmarked NIS 100 million - is NIS 3 million.[11] This sum comprises the total cost of operating the fund.

As noted only three relatively small banks with less than 10% of all credit provided by Israeli banks cooperate with the state fund. One might ask why additional banks have not followed their lead. One possible explanation is the large banks in Israel view the small business sector as a potentially minor addition to their activities, and one that entails a large allocation of resources. Since the state fund has a limited guarantee budget, there is little incentive for large banks to work with the fund. The addition of a large commercial bank, possessing substantial marketing and advertising prowess, would likely raise the demand for loans, and this would require the government to allocate new sums not originally budgeted. Table 1 shows the different terms by which the fund operates currently with the different banks.

Table 1
Government Fund Relations with Israeli Banks
(September 2003-December 2005)

Bank	Otsar Hachayal	First International	Mercantile
Period of activity	September 2003 -	October 2004 -	December 2005 -
Leverage ratio	Leverage ratio for first year - 1:5 Leverage for present year 1:6.25	1:6.25	1:6.25
State deposit (NIS, millions)	50	31.5	6
Average loan to business (NIS, thousands)	320	266	---

Source: Gil Cohen, *Fund for Small Businesses – Update* (Jerusalem: Accountant General's Office, Treasury, 4 December 2005), Ref. no. 2005-30245; Tavor Economic Consultants Ltd, Excel data for the fund's operations, September 2003-December 2005.

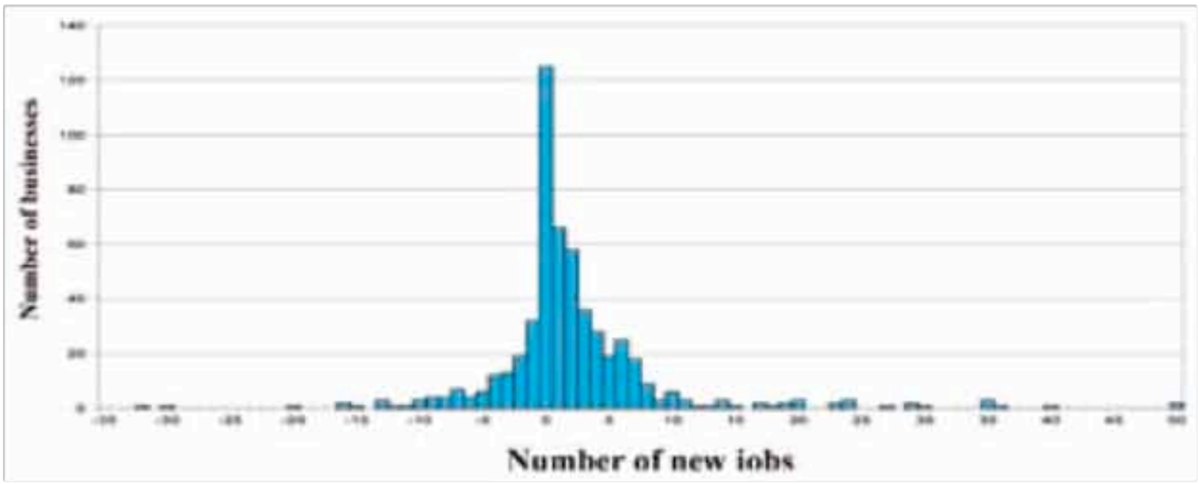
Analysis of the Fund

- **Demand for fund- guaranteed loans**: The demand by potential borrowers for loans is higher than that of the previous state funds.
- **Small business sector status**: The sector is slowly improving as reflected in an increase of loans for new investment, and a reduction in loans for working capital for ongoing activity.
- **A lack of strategic thinking**: The fund lacks a long-term plan resulting in ad-hoc budget allocation and deposits by the government. This has led to an inefficient allocation of resources by Tavor and difficulties for businesses requesting assistance from the fund. The inconsistent budgets of the current fund and lack of long-term state commitment has led the fund's inability to plan for the future and, as a result, loan applicants have faced delays or loan refusals. Michael Tavor reports that one example of this occurred in March 2004, when the fund was forced to halt operations for a month, delaying 300 loan applications.
- **Limited outreach by the fund**: Access to the fund is limited due to the lack of a budgetary allocation for advertising. The number of cooperating banks is small with uneven branch coverage throughout the country.
- **Lack of criteria**: Since no priorities for loans have been established, loans are granted on a "first come – first serve" basis. Businesses in peripheral areas or distressed areas appear to be at a disadvantage**.** Thus 50% of the loans approved are from the country's

Central and Sharon districts, while only 15% are from the south and only 6% from Jerusalem.

- **NIS 5,644 per job**: Based on Tavor's own unaudited survey of 542 out of the 1,347 businesses receiving loans during the first two years of fund activity, the number of jobs grew by 15%, with an average of 2.1 new jobs per business (see Figure 1). The actual state investment, including overhead costs for the fund (NIS 6.75 million in the period surveyed) and guarantees from loan losses (NIS 8.5 million), for the creation of each new job averages out to NIS 5,644.[12]

Figure 1
Number of New Jobs Per Loan Recipients



Based on: Tavor Economic Consultants Ltd, Excel data for the fund's operations, September 2003-December 2005.

- **Loan terms**: The fund essentially supports existing banking practices that stress pledging tangible assets and other securities at or near 100% of the loan, by providing a very high, 70% guarantee. Therefore, the fund does not encourage the banks to adopt more liberal credit practices and does not take into account the fact that many businesses, especially small ones, would have positive cash flows and the ability to meet loan payments once loan proceeds are put to work (small businesses do not usually have many qualified tangible or fixed assets to serve as collateral). It is worth noting that the development of Israel, as a young country, is based principally on entrepreneurial skills, rather than on tangible fixed assets.
- **Loan fees**: The loan fees paid by borrowers are relatively low, in comparison with the other countries.
- **The preparation of a business plan** with the help of an external advisor is not required and does not ensure approval of a loan request, but it does increase significantly the chances of the loan being approved. The rate of approvals for applications submitted by means of an external advisor is 41%, while only 24% of those submitted independently were approved. The applicant in most cases must incur an additional, substantial expense in order to obtain a loan, an expense he must pay regardless of whether the loan is approved.

- **Loan approval mechanism**: Only 50% of the completed applications (the stage of a financial assessment by Tavor) received final approval by the credit committee. Some 43% of the applications for loans did not reach the assessment stage. This may mean that the necessary documentation is too complicated for many borrowers. Perhaps this is why less than half of the applications were submitted independently without advisor assistance.
- **Waiting time**: In 2005 the average waiting time for approval or rejection of a loan application was two and a half months, much longer than for similar funds abroad. In the U.S., business loans are usually granted within only three working days. Needless to say, a long waiting period is discouraging to borrowers and harmful to those businesses in need of immediate financial assistance.
- **Loan cost**: The cost of a five-year loan of NIS 100,000 by KIEDF is lower than the cost at the state fund, and can save a borrower a total of up to NIS 6,500 over the period of the loan.
- **Bank profits**: As previously stated, the banks are authorized to charge an interest rate of Prime + 2.9% on loans from the state fund, while receiving a state guarantee of 70% on each loan. In comparison, KIEDF loans from Bank Otzar Hachayal are effectively priced at Prime + 1.8% (including a 1.3% KIEDF subsidy) while receiving an average guarantee of only 35%. Although the "risk" on some of the larger loans can be deemed higher, one must wonder why the gross profits of the banks are more than 60% higher on state loan funds when the guarantee is twice as much as the private fund.

International Experience

Many countries provide a number of tracks of assistance for the small- and medium-sized business sector, and special consideration is often given this sector when setting policy. This attitude is not solely Western; policies adapted to the needs of small business are found around the world from Tanzania to Pakistan.

U.S.

The United States Small Business Administration ("SBA") operates a number of programs offering financial aid to small businesses.[13] The SBA's main program is the "Basic 7(a) Loan Program," which enables government-guaranteed loans to small businesses. The loans are given by commercial loan institutions responsible for determining the suitability of the borrower to the program, for helping him meet the program requirements and for collection of the loan payments. The success of the lenders' work is reflected in the high rate of loan approvals, an average 90%.[14] Since 2005, Program 7(a) is financed mainly by a fee paid by the borrower.

Within the 7(a) framework there exist a number of tracks for SBA-guaranteed loans, so as to streamline the process and reduce the waiting time for loan approval. Businesses are earmarked for different tracks, with the goal of maximizing the suitability of business and potential assistance. In order to administer these different tracks, a large number of approved issuers of loans is necessary, and the SBA has granted them substantial autonomy in the loan approval process. As the program has proven to be successful over time, the SBA has increased the amount of independence granted the credit institutions.

The SBA operates three additional programs to increase efficiency:

- **The Secondary Market Program**: By facilitating the securitization of loans the Secondary Market Program lets primary lenders sell the SBA-guaranteed portion of a loan to other investors, thus reducing their own risk, while increasing the yield on the portion not guaranteed by the state.
- **Assets Sales Program**: The SBA can sell a loan portfolio or other assets it is holding, in order to better manage the overall SBA budget and its credit costs. The SBA thus exploits the efficiency of the private sector and "refinances" its budget for other programs.
- **Capital Access Program:** This program is designed to increase the supply of credit to those at relative risk in areas the government wishes to see development. Both the borrower and the lender pay (according to an agreed upon ratio) an insurance premium at an inclusive rate of between 3%-7% of the total loan granted, which the government matches. These sums are transferred to a Pooled Reserve Account that protects the lender against losses in the event of default. The lender then processes the loan according to standard procedure without government assistance, but with the security of the reserve account. This program reduces the lender's risk and enables him to fund higher risk loans that would not otherwise be given. Administrative costs are low (the processing of the loan is standard), as is the level of government intervention in the normal financial procedures between a lender and borrower. [15]

As a companion to 7(a), there is financial track 504 (the Certified Development Company Loan Program), which enables a non-profit corporation dedicated to local financial development to offer long-term financing to small businesses.[16] Generally speaking, such financing involves a loan insured by a senior lien from the private sector, covering up to 50%, a loan guaranteed by a junior lien from the non-profit, which covers up to 40% (and which is 100% backed by a guaranteed debenture of the SBA), and at least 10% in the form of the small business's private capital.[17]

Other than the federal loan programs guaranteed by the SBA, there are many state and local loan programs that promote local small business. Louisiana, for example, whose policy is to regulate the flow of private capital, offers long-term loans and additional financial aid to develop and maintain small business in Louisiana, create new jobs, and expand opportunities for small businesses, especially those situated in depressed areas.[18]

Recommendations

The following changes would improve the efficiency of the current fund and increase benefits for small and medium-sized businesses in Israel:

- The small business loan fund and coordinating company should be budgeted consistently and continuously in order to increase operational efficiency and reduce loan processing time.
- Any expansion of the fund should be based on terms more favorable to the state. While incentives may have been necessary to secure bank cooperation with the government after previous failures the success of the current model and comparative costs with

other programs such as KIEDF evidence clearly that the risk to the banks given the 70% government guarantees does not warrant the current interest rate.

- Although it is too early in the loan cycle of initial loans to determine actual loan loss rates for the fund, it seems that the government should be able to increase the fund leverage in the event of additional budget allocation to expand the program further assuming losses approximate the KIEDF 12 year loan loss rate of 1% of all credit guaranteed since the inception of the program.
- Assuming no significant increase in funding, allocation criteria should be established to facilitate credit on a priority basis to meet regional and sectorial needs. The SBA 504 track model, which targets regional economic development, could be very effective for stimulating economic development in geographically depressed areas to create employment opportunity.
- Advertising funds should be budgeted to promote the fund and its accomplishments to date, to encourage increased applications from small businesses.
- The efficiency of the loan approval process should be improved so as to reduce the application to approval time frame. A credit scoring model would facilitate efficiency in the loan approval process.
- Business plans prior to receiving loan approval and after, as the business expands, should be prepared by a limited number of financial consultants approved by the fund. Fees for business plan preparation should be pursuant to a standard, predetermined price scale and payable by the borrower only upon approval of the loan. This system, successfully used by KIEDF for many years, encourages fiduciary responsibility to the fund, improves screening of applications, expedites the loan process and insures borrowers pay for what they get.
- Fund management should be awarded to a least two companies so as to create a competitive environment for fund operations. Competition would (1) enhance the number of applications; (2) expedite the approval process; (3) provide comparative statistical reporting; (4) permit loan loss comparisons.
- A Capital Access Program modeled after the SBA program in the United States should be adopted as a way to expand the current fund and increase credit available to higher risk small business that normally would not qualify for the current fund. Other SBA models should be examined as well.

1 Business Data Israel Ltd. *Finance funds for small businesses, special review* (Beni Barak: Business Data Israel, January 2006), pp. 25, 40, http//www.asakim.org.il/upload/kranot05.pdf (26 March 2006).

2 For additional information on the Koret Fund: http://www.kiedf.org (25 March 2006).

3 Avner Vered, *Designated finance funds for small businesses in Israel* (The Israeli Small and Medium Enterprises Authority), p. 1.

4 Ministry of Finance, *State Budget: Proposed budget 2001*, pamphlet 22 (Jerusalem: Ministry of Finance, October 2000), p. 40, http.//www.mof.gov.il/budget2001/doc/tasiya.doc (18 March 2006).

5 This also includes loans the banks assume will be in default. Tavor Economic Consultants Ltd. (Presentation to the Accountant General, March 2005), slide 4.

[6] Shay Koren, manager of the Fund for Small and Medium Businesses, Tavor Economic Consultants Ltd., interview with the author, 7 March 2006.

[7] Ilanit Werner, State Guarantees Director, Ministry of Finance, interview with author, 27 December 2005.

[8] Subcommittee for the appraisal of the small businesses crisis, Knesset' Finance Committee, Sixteenth Knesset, First Session, *Protocol 2* (8 July 2003), p. 2, http://www.knesset.gov.il/protocols/data/rtf/ksafim/2003-07-08.rtf (10 June 2006). The amount was calculated by Tavor Economic Consultants Ltd. according to an average exchange rate of $1 = NIS 4.636, the conversion rate was taken from: http://www.oanda.com/convert/fxhustor (10 June 2006).

[9] Tavor Economic Consultants Ltd, Financing for small- and medium-sized businesses, http://www.tavot.bix/small_b_n.htm (25 March 2006).

[10] *Public tender for the selection of a coordinating body between the government and the Government Loan Fund for Small and Medium Sized Businesses* (Jerusalem: The Treasury, 2005), 2005-9060.

[11] Werner, interview.

[12] Based on Tavor Economic Consultants Ltd, Excel statistics of the Government Fund activities from September 2003 – December 2005. These statistics are based on a survey of 542 businesses, representing 40.2% of the businesses that received loans in the stated period, receiving 41.6% of the total value of loans. The results received were extrapolated onto the overall total of businesses granted loans. It should be noted the job statistics are Tavor's.

[13] United States Small Business Administration, http://www.sbaonline.sba.gov/ (10 June 2006).

[14] Wenli Li, "Government Loan, Guarantee, and Grant Programs: An Evaluation" *Economic Quarterly,* Vol. 84, no. 4 (Federal Reserve Bank of Richmond, Fall 1998), p. 49.

[15] Department of the Treasury, *Capital Access Programs: A Summary of Nationwide Performance* (January 2001), http://www.treasury.gov/press/releases/docs/cap01.pdf (12 May 2006).

[16] United States Small Business Administration, *Financing*, SBA Loan Topics, http://www.sba.gov/financing/sbaloan/cdc504.html (28 March 2006).

[17] Ibid.

[18] The Official Website of the State of Louisiana, http://www.louisiana.gov/led/business_incentive_sevices/small_business_loan_program_rules.asp

[19] Jalal Akhavein, W. Scott Frame, Lawrence J. White, *The Diffusion of Financial Innovations: An Examination of the Adoption of Small Business Credit Scoring by Large Banking Organizations* (Paper presented at the Federal Reserve Bank of Philadelphia, 17 May 2002), http://www.phil.frb.org/econ/conf/innovations/files/akhavein.pdf (12 May 2006).

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