



Facilitating access to finance

**Discussion Paper on Credit
Guarantee Schemes**

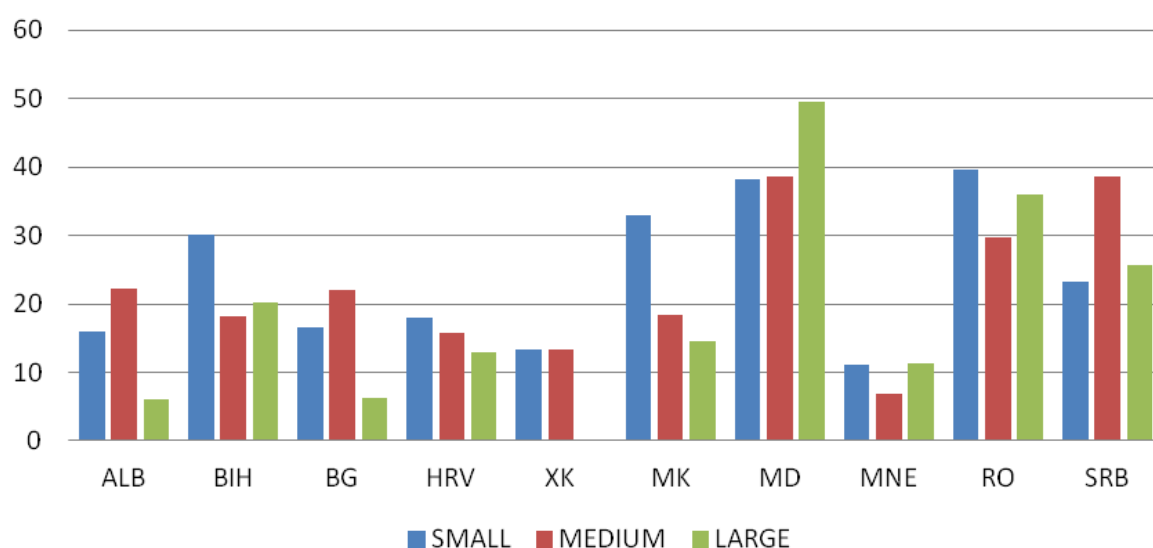


CREDIT GUARANTEE SCHEMES

1.1 Introduction

Accessing finance is a challenging task for firms. However, these financing constraints tend to be more difficult for SMEs to overcome than for larger firms. In SEE, on average 23.9 percent of small enterprises have identified access to finance as a major constraint compared to only 18.2 percent of large firms. This limited access is mainly associated with the high administrative costs of small-scale lending, the underdeveloped financial system, the high risk perception attributed to small enterprises, asymmetric information and small firms' lack of collateral.

Figure 1. Percentage of firms identifying access to finance as a major constraint



Source: BEEPS

In order to lessen the financing constraints faced by SMEs, governments, NGOs and the private sector have developed initiatives such as credit guarantee schemes (CGSs). CGSs first emerged in Europe in the 19th and the early 20th centuries. Currently, there are over 2,250 schemes implemented in different forms in almost 100 countries (Green, 2003). CGSs provide guarantees to groups that do not have access to credit by covering a share of the default risk of the loan. In case of default, the lender recovers the value of the guarantee. This paper will first investigate the reasons behind the emergence of guarantee schemes and review their impact. It will also look into the types of schemes available and distil international good practices in CGS design and management.

1.2 The emergence of credit guarantee schemes

1.2.1 Overcoming information asymmetries

Information asymmetry is a core reason commercial banks are generally reluctant to provide loans to SMEs. In most instances, SMEs are unable to provide information on their creditworthiness –

they tend to lack appropriate accounting records and collateral. This leads to uncertainty on the project's expected rates of return and the integrity of the borrower. Gathering such information on SMEs can be challenging and costly.

Lending administrative costs tend to be higher for smaller firms. Obtaining information requires more resources as a percentage of the underlying loan. Visiting borrowers and monitoring their activities is expensive and not always economically rational when a loan size is small. For instance, studies have shown that the Colombian financial institution "Caja Social" incurs administrative costs ranging from 11 to 13 percent of the portfolio's value per year for small loans (Green, 2003).

Adverse selection is another problem stemming from information asymmetry. In this context, adverse selection starts with the market phenomenon whereby the probability of default increases with the interest rate. As interest rates increase, safer borrowers are driven out of the lending pool while riskier borrowers remain. This leads to an increasingly riskier portfolio of loans. For this reason, banks are reluctant to raise the interest rate above a certain level. Instead, they prefer to maintain the quality of the borrower pool. However, banks' inflexibility in increasing interest rates prevents many SMEs, which are typically riskier investments, from obtaining loans even if they would be willing to pay the higher interest rate. The result is credit rationing.

Both adverse selection and lending administrative costs can result in a selection process based only on firm-size and collateral. As a consequence, profitable projects that don't meet these conditions may be unable to obtain financing, resulting in a suboptimal allocation of credit. CGSs can help banks overcome information asymmetries by aiding accurate identification of lending risk and improving banks' ability to make appropriate lending decisions (Levitsky, 1997).

1.2.2 Diversifying or transferring risk

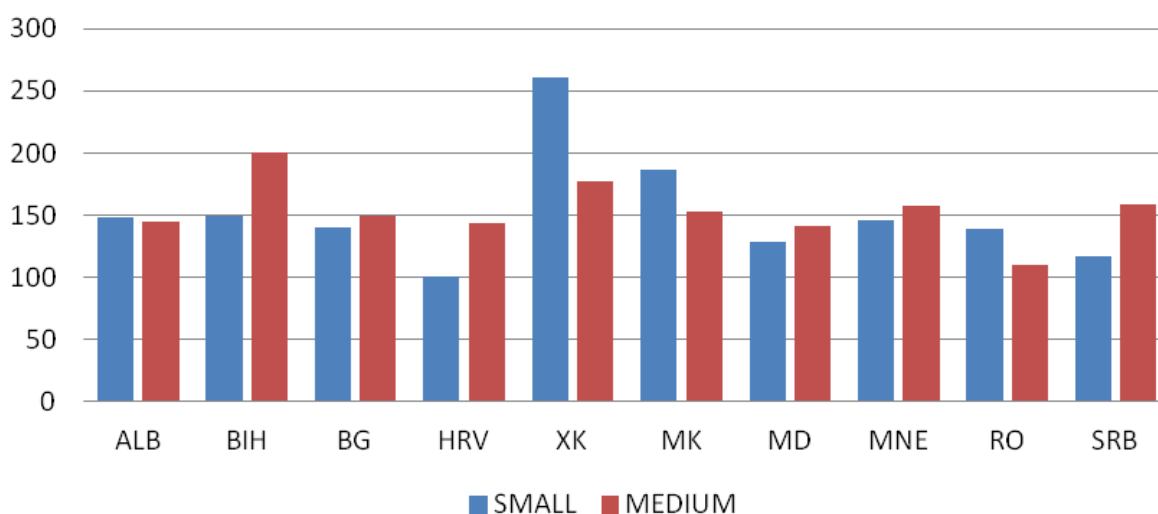
As mentioned earlier, commercial banks often have a difficult time assessing smaller firm risk due to a lack of information. Moreover, SMEs are more vulnerable in the wake of harsh economic conditions, and their mortality rates are relatively high. The situation is likely compounded in developing economies by weak creditor and property rights, the informal economy and non-existent or ill-enforced collateral registration. Thus, lending to SMEs may carry higher risks.

CGSs can be a mechanism of risk transfer and diversification. By covering part of the default risk, a lender's risk is lowered – guarantees secure repayment of all or part of the loan in case of default. In essence, CGSs absorb an important share of borrower risk. CGSs can also compensate for factors such as insufficient collateral and weak creditor rights.

1.2.3 Reducing collateral requirements

Banks' lending decisions tend to be based on the amount of collateral available. Collateral reduces lending risk. Arguably, a borrower who is willing to offer a higher level of collateral, particularly personal collateral such as a house, has a higher intention of repaying the underlying loan. Additionally, collateral provides insurance to a bank – if the firm defaults on its loan, the bank has recourse to the collateral used to obtain the loan. Selling the collateral allows the bank to recover part or all of the value of the defaulted loan. However, many firms do not possess enough assets to cover the collateral requirements of banks. Thus, deficient collateral is one of the main reasons small firms are unable to obtain credit. Smaller firms in SEE are required to put up on average 152 percent of the loan value as collateral; medium firms need 154 percent. European Union (EU) countries average only 100 to 120 percent of the loan value (World Bank, 2008).

Figure 2. Value of collateral needed for a loan as a percentage of loan value



Source: BEEPS

CGSs can alleviate the high collateral requirements demanded by banks. SMEs are perceived as a highly risky group. Thus, a bank wanting to offer an SME a loan would need to either apply a rate that covers this risk or demand a significant amount of collateral. However, when the SME provides a guarantee, the bank can make the loan at a lower interest rate. In instances mentioned earlier where banks choose not to increase the interest above a certain level in order to maintain the quality of the borrowing pool, CGSs allow firms with insufficient collateral to access the lending market. Since these firms would be otherwise excluded from the lending market, the result is higher overall lending.

Credit guarantee schemes are thus designed to diminish the risk associated with lending to SMEs. As already mentioned, they can reduce information asymmetry and alleviate high collateral requirements. Therefore, CGSs can improve loan terms and facilitate access to formal credit for small firms. Additionally, by allowing loans to be made to borrowers that otherwise would have been excluded from the lending market, these firms are now able to establish a repayment reputation that itself can, in the future, act as a type of collateral. Finally, by extending more loans to smaller businesses, lending institutions gain experience in managing these types of loans, encouraging further development in this market segment. Nevertheless, the extent to which credit guarantee schemes actually provide these benefits is a major area of debate. Experience suggests that credit guarantee schemes do play a role in expanding credit to SMEs. However, empirical evidence on the exact nature and size of the impact of CGSs is inconclusive.

1.3 The impact of credit guarantee schemes

1.3.1 Financial sustainability

Some sort of outside assistance, especially initially, is usually required to start a CGS. Credit guarantee schemes are time and resource intensive. It is possible for credit guarantee schemes to stand on their own, without outside assistance. For example, sufficient revenues can be raised through registration fees. However, care must be taken to ensure the fee is not too high to discourage borrowers from taking advantage of the CGS, but not too low to prevent the CGS from covering its costs.

1.3.2 Credit additionality

Credit or financial additionality refers to the extra loans that would not have come about without the credit guarantee scheme. Measuring additionality is difficult (Levitsky and Prasad, 1987). In fact, only a few cases of additionality have been “proven”, and thus experts remain sceptical as to whether CGSs actually cause additionality. However, Levitsky has argued that additionality is possible if a CGS is properly designed and implemented. He estimates that in such cases CGSs create, on average, 30 to 35 percent financial additionality (Levitsky, 1997). Since general additionality is hard to determine, this report will present some empirical evidence illustrating additionality in specific cases, e.g. Chile (see Box 1).

Box 1. Guarantee Fund for Small Business (FOGAPE)

The Partial Credit Guarantee Fund (FOGAPE) in Chile is administrated by a governmental agency. In 2004 FOGAPE had a total equity of USD 52 million. The number of guaranteed loans has risen from 200 in 1998 to approximately 34,221 in 2004. In 2004, the total amount of loans covered by the guarantee fund was USD 472 million and the average coverage ratio was 65 percent. The maximum coverage ratio can go up to 80 percent for loan amounts below USD 90,000 and up to 50 percent for amounts above USD 90,000.¹ The registration fee ranges from 1 to 2 percent depending on the borrower’s default history.

The success of the Partial Credit Guarantee Fund is due to many factors, including:

- A strong regulatory and supervisory system;
- Transparency and fairness – for example guarantees are allocated to financial institutions through a sealed bid auction;
- An intensive publicity and promotional campaign launched by the government to explain the utility of the programme. Additionally, training programmes were provided to commercial banks to acclimate them with FOGAPE and its policies and financial institutions were invited to participate in FOGAPE’s committees.

Larraín and Quiroz (2006) investigated the impact of the fund. Their findings indicate that FOGAPE achieved not only credit additionality but also economic additionality. It appears that customers of FOGAPE are 14 percent more likely to get a loan than non-customers. The scheme appears to have contributed to an increase in the volume of credit by 40 percent; turnover in the companies benefiting from the fund increased by 6%. Nevertheless, it is important to note that the study only looked at loans made in larger cities. There are still some questions about the impact of FOGAPE in rural areas.

Source: Larraín, C. y Quiroz, J.; *Estudio para el fondo de garantía de pequeños empresarios*, Banco del Estado. Ed. Mimeo. March 2006. Llisterri, J., Rojas, P. Mañueco, V., López, A., García, T., *Sistemas De Garantía De Crédito En América Latina*, Banco Interamericano de Desarrollo, Washington, DC 2006.

1. USD 900 00 is equal to UF 3 000 (unidad de Fomento); 1 UF is equal to USD 30.

1.3.3 Economic additionality and spillover effects

Credit guarantee schemes have the opportunity to contribute not only to credit additionality, but also to technology and knowledge spillover and economic additionality, e.g. increases in profit and/or employment. By improving access to formal credit, CGSs help enterprises acquire finance for investments which can increase productivity (see Box 2).

Box 2. Korean Technology Credit Guarantee Fund (KOTEC)

KOTEC was founded in 1989 by the Korean Government as a not-for-profit guarantee institution under the new "Korea Technology Finance Cooperation Act". KOTEC provides credit guarantees to new technology-based enterprises. It also promotes the growth of technologically strong SMEs. Since its foundation, KOTEC has provided a total of USD 99.7 billion in guarantees.

KOTEC provides different types of services such as:

- Technology appraisal undertaken by a national network of Technology Appraisal Centres (TACs).
- Advisory services to encourage customer-oriented products and services. These include consultation services to encourage technology development among SMEs and help SMEs overcome managerial and technological obstacles.
- Support systems for company restructuring and technology transfer, including financial and legal advice, help in formulating business strategies, etc.

Evidence has shown that KOTEC has had a positive effect on sales growth and productivity in the firms to which it caters. In particular, the firm evaluation process and the system to support technology implementation have contributed to a high survival probability of loans (Kang, J W and Heshmati, A (2008); Roper. S., 2009).

Source: <http://www.kotec.or.kr/>, Roper. S., *Credit Guarantee Schemes: a tool to promote SME growth and innovation in the MENA Region*, Warwick Business School, UK for the 3rd MENA-OECD Working Group on SME Policy, 26th October 2009, Paris.

Many CGSs also provide services such as consulting and training to entrepreneurs. Although general evidence on whether such schemes are beneficial is lacking, some individual cases indicate that these systems can be important contributors to increased new firm activity.

Box 3. Canadian Small Business Financing Program (CSBF)

The Small Business Loans Act (SBLA) established the first credit guarantee scheme, CSBF, in Canada in 1961. CSBF is based on portfolio management. Loan and guarantee approval is handled entirely by lenders. The programme guarantees almost 10,000 loans worth more than 1 billion Canadian dollars each year. The fund can finance up to 500,000 Canadian dollars for any single business. Registration fees are 2 percent of the loan, and are paid by the borrower.

A 2001 report by Riding and Haines showed that, thanks to the SBLA programme, about 66,000 additional jobs were created in 1995. 1.53 jobs on average were created by firms participating in CSBF, while job creation was only 0.16 in the firms that did not participate in the programme.

Source: www.ic.gc.ca/csbfa; Riding. A; Haines. G. (2001); *Loan Guarantees: Costs of Default and Benefits to Small Firms*

1.4 The different forms of credit guarantee schemes

1.4.1 Types of guarantee schemes

By asking questions such as, "How has the fund been capitalised? What is the ownership structure? How are the guarantees delivered?" we can identify four major types of guarantee funds: public guarantee schemes, corporate funds, international schemes and mutual guarantee associations (Green, 2003).

- *Public Guarantee Schemes*: public guarantee schemes are established by public policy. They usually involve state subsidies, especially initially. Typically, they are managed by a private organisation or an administrative unit of the government. An advantage of this system is that, in case of loan default, the guarantee is paid out directly from the government budget. This gives such a scheme higher credibility within the banking sector.

Box 4. The Small Business Development Fund (SBDF)

Slovenia's Small Business Development Fund (SBDF) was established in 1992 by the Government of Slovenia to promote the establishment and development of small business units. It guarantees both long-term and short-term loans, in collaboration with banks. All forms of support are provided on the basis of a public invitation to lenders to participate in the programme. First, a loan must be accepted by a bank. Then the board of directors, which consists of representatives from banks and government, takes the final decision on which applications to guarantee under the fund. In 1997, 28 banks had signed an agreement to offer guarantees with the SBDF. For long-term loans the SBDF guarantees up to 80 percent of the purchase price of the equipment or plant bought with the loan.

The SBDF also has a series of regional guarantee funds (RGF) that operate through Regional Business Centres. RGFs receive funds from both the SBDF and from local resources. At the end of the 1990s, the fund provided a 50 percent guarantee of credit for amounts between USD 6,000 to USD 60,000. Repayment periods span from one to five years and interest rates are generally around 6%.

In the late 1990s, RGFs operated with a fund of USD 2 million and the SBDF maintained a fund of USD 23 million. In 1996 and 1997, the SBDF fund benefited from an influx of capital coming in from the privatisation programme following the Privatisation Law of 1995. 9.5 percent of funds coming from these privatisations were allocated to the SBDF.

Source: OECD, 2000, Financing Newly Emerging Private Enterprises in Transition Economies.

- *Corporate Guarantee Schemes*: corporate guarantee schemes are generally funded and operated by the private sector, e.g. banks and chambers of commerce. Corporate guarantee schemes have the advantage of being managed by experienced corporate leaders, and generally benefit from the direct involvement of the banking sector.
- *International Schemes*: international schemes are typically bilateral or multilateral government or NGO initiatives, e.g. the ILO, UNIDO or the European Investment Fund. Often, international schemes combine both a guarantee fund with technical assistance to firms.

Box 5. USAID's Loan Portfolio Guarantee Schemes (LPG)

USAID's Loan Portfolio Guarantee Scheme (LPG) does not provide funding to any particular organisation. Instead, it facilitates public-private partnerships. This is done through a series of international bilateral commercial guarantee agreements between USAID's Centre for Growth and privately-owned commercial banks.

USAID uses the Development Credit Authority (DCA) to stimulate lending through the use of credit guarantees. DCA was established in late 1999 and now has more than 225 partial credit loan and bond guarantees. The DCA has enabled approximately USD 1.8 billion of private capital to be loaned in over 60 countries. The DCA offers four guarantee products: loan guarantees, loan portfolio guarantees, bond guarantees and portable guarantees, all of which cover up to 50 percent of the default risk. Loan amounts typically range between USD 5 million to USD 10 million, but loan guarantees have been as low as USD 1 million and as high as USD 40 million. USAID also combines technical assistance with the DCA.

Source : www.usaid.gov

- *Mutual Guarantee Schemes:* mutual guarantee schemes are also sometimes known as mutual guarantee associations, societies or funds. They are private and independent organisations formed and managed by borrowers with limited access to bank loans. Although they are largely funded from membership fees, etc., in many instances, they operate with some form of government support. Mutual guarantee schemes benefit from the active involvement and experience of their members.

A 2008 World Bank study of 76 guarantee schemes across 46 developed and developing countries has shown that mutual guarantee funds tend to operate in high-income countries while most middle and low-income countries have publically operated funds. The report also found that public schemes are, on average, younger than mutual funds and are more likely to operate in emerging markets. The study also suggests that mutual guarantee schemes tend to be financially more sustainable due to the ownership and involvement of their members.

1.4.2 Structure of mutual guarantee associations (MGA/MGS)

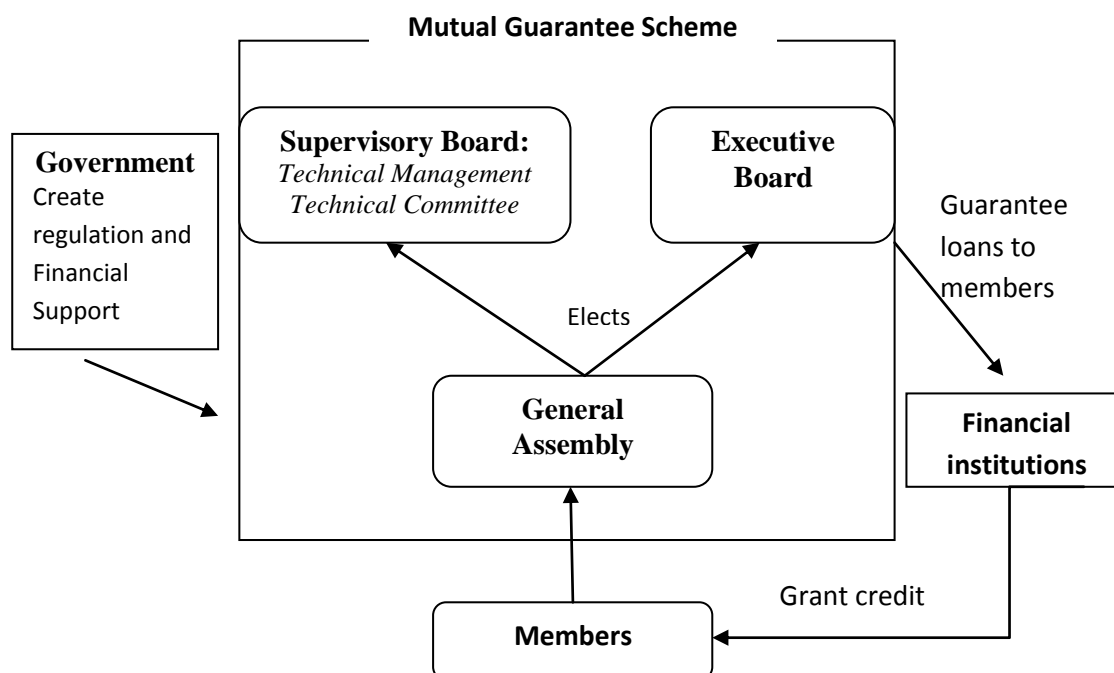
As mentioned earlier, a mutual guarantee association is an association of small firms with limited access to credit. The MGS aims to bridge the gap between banks and entrepreneurs. Each member contributes to a common fund that is used to make guarantees on loans procured by its members. An important characteristic of an MGA is that it also relies on social capital, i.e. the fund creates social norms and positive peer pressure to encourage repayment amongst its members. "They provide guarantees for one another, benefit from [them] and become liable for each other's debt" (De Gobbi, 2002). Although MGA organisation varies from fund to fund, they typically share some common characteristics, for instance they generally have:

- A General Assembly composed by all members. The General Assembly determines the regulations for issuing guarantees and elects members to the Executive and Supervisory Boards. It can approve or veto actions planned by the Boards.
- An Executive Board that monitors and supervises the technical management of the fund and takes the decision on which guarantee applications to accept. The Executive Board also decides whether to admit new members to the fund.

- The Supervisory Board that monitors the guarantee contracts and the fund's financial situation.

Even if MGSs are independent, often they are supported directly or indirectly by government. In some instances, the government provides the appropriate legal and regulatory framework within which MGSs can operate. In other cases, the government provides financial support to the fund.

Figure 3. Structure of a mutual guarantee scheme



Source: Green, A. (2003), Credit Guarantee Schemes for Small Enterprises: An Effective Instrument to Promote Private Sector-Led Growth? UNIDO

1.4.3 Guarantee schemes versus mutual guarantee associations

Due to their structure, MGAs have a competitive advantage over the other types of guarantee funds. For that reason, it is arguable that performance might be better in MGAs than in public guarantee schemes. One of the main advantages of MGAs is their expertise and knowledge of the business sectors covered by the fund, the region in which the MGS is based and the market trends and production techniques of the enterprises whose loans are guaranteed by the fund. Thus, they are often in a better position to evaluate the feasibility and risk of a project. This knowledge advantage possessed by MGAs can decrease information gathering costs and therefore reduce overall transaction costs.

Moreover, MGAs create social capital from peer monitoring and peer pressure, increasing loan repayment. However, for this social capital to be fully exploited, some conditions are necessary (Tschach, 2000):

- Members should have full knowledge of the economic and social situation of borrowers. This enables them to easily identify the credit capacity of borrowers.

- It should be difficult for members to leave behind a debt, e.g. by moving away suddenly.
- Loan default should be accompanied by social repercussions from other group members. In essence, there should be negative social factors which encourage members to make good on their loans.

MGSs can also give members a more powerful bargaining position. This is particularly important for SMEs. MGSs play the role of a quasi-borrower vis-à-vis banks and are a more influential negotiating partner than a single small firm. Members are thus able to obtain loans with better conditions and possibly lower costs (Green, 2003).

Box 6. Confidi

Modern MGSs appeared in Europe in the 1940s and since then they have grown in both size and number. In 2000 MGSs provided guarantees worth over EUR 14 billion to more than 2 million SMEs (De Gobbi, 2003)

Confidi, the first Italian MGA, was created in the late 1950s. Today it operates over 700 individual MGAs in many different sectors and has over 940,000 SMEs as members (De Gobbi, 2002). Confidi has gradually spread from central Italy to northern Italy and now exists throughout the country. Each MGA operated by Confidi has on average 2,000 members. The membership structure is based on the principle of equality: each member has one vote regardless of its size. In some cases, Confidi has also benefited from government assistance and money from the EU. However, subsidised credit is only a small proportion of overall lending and has heavy and expensive procedures.

Some important characteristics that have made Confidi a success are its:

- High quality technical management;
- Focus on risk sharing and strengthening of SMEs: the large size of the MGAs under Confidi has led to decreased levels of peer pressure and social capital. Despite this drawback, Confidi has been able to maintain its success because of the principle of equality amongst its members. By empowering vulnerable SMEs, it has strengthened the links between SMEs, SME associations and the MGAs. This has given the MGAs in Confidi a strong negotiating position and allowed them to obtain more favourable loan conditions (De Gobbi, 2003).

Source: De Gobbi, M. (2002), Making Social Capital Work: Mutual Guarantee Associations for Artisans, Social Finance Programme, Employment Sector, International Labour Organisation, September 2002.

1.5 Design of credit guarantee schemes: identifying good practices

The main objective of a credit guarantee scheme is to ensure that firms can obtain financing for solid investment projects. In particular, CGSs aim to assist SMEs that are otherwise creditworthy but don't have adequate collateral to obtain a loan at a reasonable interest rate. A successful scheme needs to be able to help riskier SMEs obtain financing by reducing the risk of a loan extended to them, limiting transaction costs and guaranteeing payment in case of default. The question, however, is whether such requirements can be translated into a CGS that is not only sustainable but also creates financial and economic additionality. Self-sustainable funds exist in many different countries, e.g. Italy's Confidi schemes or Canada's SBLA scheme (see Boxes 6 and 3, respectively). However, only a few CGSs have demonstrated financial or economic additionality. In the next section, we analyse good practices that can contribute to a successful guarantee fund, and hopefully ensure it achieves both sustainability and additionality. Here, we consider three main challenges for guarantee schemes: (i)

regulation and supervision; (ii) the role and involvement of the private sector; and finally (iii) the appropriate design of CGSs.

1.5.1 Risk sharing

An improperly designed guarantee scheme can increase moral hazard among borrowers by reducing the default risk they otherwise would incur (i.e. by providing part of the collateral required to obtain the loan). This can lead to more “strategic defaults” from borrowers – because part of the collateral does not belong to the borrower, he has a higher incentive to default. However, a properly designed guarantee scheme can limit moral hazard. For this to occur, it is important that the loan risk is shared amongst the lender, the borrower and the guarantors.

The extent to which each party should share in the risk is a delicate balancing act. The guarantor should accept enough risk to be able to persuade banks to participate in the scheme. In fact, 100 percent coverage exists in countries such as Canada, Japan, and Luxembourg. A World Bank study from 2008 revealed that among the 76 schemes in 46 developed and developing countries, 40 percent of them offer this option (World Bank, 2008). However, a 100 percent coverage rate is subject to greater moral hazard. Not only does it increase the strategic default option of borrowers, but it also reduces banks’ incentives to properly assess and monitor risk.

Coverage rates below 50 percent reduce the potential for moral hazard and encourage the adequate assessment and monitoring of loans. On the other hand, a coverage rate below 50 percent reduces banks’ incentives to participate in the guarantee programme, especially because loan administration costs can be quite high. Some countries with low coverage rates have been able to maintain the attractiveness of their scheme by using other financial incentives. The national guarantee fund in Egypt, despite having a low coverage rate, still managed to guarantee USD 85 million in loans in 1995 after only four years in operation. In part, this was achieved by offering other financial incentives in addition to guarantees. In Thailand, however, a similar scheme with the same coverage rate as that offered in Egypt only managed to secure USD 51 million in loans after 10 years in operation. One reason contributing to their lower usage levels was a lack of other financial incentives (Levitsky, 1997).

Such experiences suggest that coverage rates should generally be between 60 and 80 percent (Levitsky, 1997). Rates in this interval are high enough to encourage lender participation and yet low enough to limit moral hazard. From the 76 schemes studied by the World Bank, the median coverage rate was 80 percent. The study also found no correlation between a country’s economic and financial development and maximum coverage ratios (World Bank, 2008).

Some countries offer more complex coverage rates. For example, Italy and Mexico offer an array of guarantee rates. Rate levels depend on the risk assessment and the type of loan. In another interesting example, the Chilean fund FOGAPE determines coverage rates based on an auction (see Box 7).

Box 7. The Auction System of The Chilean Fund FOGAPE

A main feature of the Chilean guarantee scheme FOGAPE is the auction system used to distribute guarantees and set coverage rates. In fact, in 2005 a similar system, modelled after the FOGAPE auction system, was adopted in Mexico. The bidding takes place four to six times per year. Only supervised financial institutions can participate. Financial institutions participating in the system are responsible for analysing the risk of loans and respecting the conditions set forth by FOGAPE.

In every auction FOGAPE distributes resources for three types of credit guarantees: (i) 50 percent of total resources go to short-term loans; (ii) 30 percent go to long-term loans, exporters and emerging companies; and (iii) the remaining resources go toward other credit. Tenders are selected based on the coverage rates proposed by lending institutions – lower coverage rates are selected before higher coverage rates. Once the tenders have been accepted, FOGAPE establishes a contract with the winning financial institution fixing the coverage and commission rates, and outlining the contractual obligations of both parties in the case of default. Interestingly, the auction system has led to decreasing coverage rates – average coverage rates have fallen from 80% when initiated in 2000 to 65% in 2004.

Once the contract is concluded between FOGAPE and the lending institution, loans based on the guarantees must be distributed to borrowers within a two month time frame. If during that period, the guarantee is not used, FOGAPE calls for a new bid. In 2005, lending institutions typically used 85 percent of the resources available to them. In order to increase usage, FOGAPE recently required that the contracting financial institution must use 90 percent of the guarantees awarded to them.

Another weakness in the FOGAPE system was recently fixed. In 2005 one financial institution obtained the majority of the resources distributed by FOGAPE. As a result, FOGAPE recently established a cap of 66 percent of total resources that one single contracting financial institution can receive.

Source: Llisterra, J., Rojas, A., Mañueco, P., López, V., Garcia, A., (2006); *Sistemas De Garantía De Crédito En América Latina*, Banco Interamericano de Desarrollo, Washington, DC 2006.

1.5.2 Fees

The fees charged by CGSs are also an important design aspect. These fees impact not only the incentives lenders and borrowers have in participating in the programme, but they also are a key factor determining the financial sustainability of the fund. Fees must be high enough to cover administrative costs, but low enough to ensure adequate lender and borrower participation. Experience has shown that it is unrealistic to expect a CGS to cover its full costs through fees, but it can still cover at least the administrative costs of running the scheme (De Gobbi, 2002).

In general, the percentage and the way fees are applied vary among different schemes. There are schemes where a registration fee for processing the application is required. In Europe as well as in developing countries, the fee is typically about 1 percent of the loan amount. Others schemes usually impose an annual or a per-loan fee that ranges from 1 to 2 percent. According to Levistky, fees above 5 percent render the scheme too expensive for adequate lender and borrower participation.

Among the 76 countries studied by the World Bank, 56 percent of fees were paid by borrowers and 21 percent were paid by the financial institution receiving the guarantee. Only 15 percent of schemes impose a membership fee, while 30 percent impose an annual fee and 48 percent of the 76 schemes charge a per-loan fee. 57 percent of the schemes base the fee on the amount of the guarantee; 26 percent of them base it on the loan amount (The World Bank, 2008). A risk-based pricing structure is only available in some countries, e.g. Colombia – the Fondo Nacional de Garantía (FNG) charges different fees according to risk. Low risk applications with guarantees up to 40 percent are charged a 3 percent fee. Higher risk applications with a 70 percent coverage rate are offered a 4 percent fee (Levistky, 1997).

1.5.3 Types of loans

Another important element that policy makers must take into account is whether a scheme should provide individual or portfolio loans. A loan-level or individual model applies when applications are approved by the guarantor. In this case, there is a direct link between the borrowers and the lenders

since the application assessment is done on case-by-case basis. This allows for a more careful risk management and likely reduces the probability of moral hazard. Such a scenario probably results in a higher quality loan portfolio. However, this method can also be more costly for the fund to manage. According to the World Bank, 72 percent of credit guarantee schemes use this selective or individual loan approach (World Bank, 2008).

If the objective of the scheme is to increase guarantee and credit volume, the portfolio model might be a better approach. Under this approach, the guarantor negotiates the criteria of the portfolio. For example, a fund can specify that loans made with its guarantees are targeted to the SMEs sector, a particular location or a specific loan size. However, the portfolio model does have some disadvantages. Because the screening process is less meticulous, default rates tend to be higher. Moreover, since the portfolio is based on specific lending objectives, there is less risk diversification. Managers are thus confronted with a trade-off between lending volume and portfolio quality.

International experience has shown that only 14 percent of the 76 schemes studied by the World Bank use the portfolio model. 9 percent of schemes use a combination of the loan-level/individual model and portfolio model. The study did not find any indication that country income level or financial development played a role in determining which model was used by the guarantee schemes in different countries (World Bank, 2008)

1.5.4 Defaults

The default rate is an important indication of a scheme's sustainability. When applications are appropriately assessed and monitored, an adequate default rate is possible. Levitsky considers that a sustainable scheme should aim to have a default rate between 2 and 3 percent. Newly established schemes in developing countries might consider a higher default rate (i.e. over 5 percent) in their early years of operation. However, prolonged high default rates should be avoided.

A scheme's credibility is also based on how defaults are handled. Guarantee payouts should only be used as a last resort. Before it comes to this, guarantors (or lenders) should negotiate rescheduled payments. This, however, requires experienced staff in the guarantee scheme able to handle the subjective nature involved in renegotiating payment plans. In fact, many schemes have failed due to unqualified and inexperienced personnel and unclear management criteria. For instance, in Côte d'Ivoire, 250 applications were considered by the fund between 1968 and 1981. Due to the absence of clear selection criteria, 90 percent of them (221 requests) were accepted by the management committee. Most of the firms which received a guarantee eventually stopped business activity, and 37 defaults crippled the financial health of the fund. In 1989, the fund was required to repay almost 850 CFA franc to lenders (Balkenhol, 1990).

The Japanese Credit Guarantee Corporation has had success decreasing the amount of guarantee claims it must pay out by vigorously pursuing borrowers when they default on loans. Through their efforts, they have achieved a 53 percent recovery rate (World Bank 2008).

1.5.5 Risk management

In order to reduce the exposure of schemes to default and diversify risk, funds might use risk management mechanisms such as reinsurance, loan sales or portfolio securitisations. However, these mechanisms require relatively well developed local capital and financial markets. Nevertheless, the World Bank study revealed that 76 percent of the schemes studied use risk management tools. 20 percent purchase some form of loan insurance, 10 percent securitize the loans portfolio and 5 percent use risk management strategies (World Bank, 2008).

An example of a reinsurance mechanism is a counter- or co-guarantee. Counter-guarantees are provided by the government or an international financial entity. They provide indirect protection – the counter-guarantor assumes part of the risk associated with guaranteeing a loan. One negative consequence of a counter-guarantee system is that moral hazard increases. For this reason, it is advisable to have a counter-guarantee cover only a limit amount of the risk. However, a positive consequence of the counter-guarantee system is that it helps increase private sector confidence in the guarantee scheme.

Box 8. Portugal Mutual Counter-Guarantee Fund

The “Fundo de Contragarantia Mutuo” (FCGM) was created in association with the European Investment Fund (EIF) in 1998. The Counter-Guarantee Fund was created to both leverage the capacity of mutual guarantee companies and ensure the solvency of the mutual guarantee system. By law, the fund must reinsure all guarantees provided by mutual guarantee companies. The fund itself benefits from risk coverage provided by the European Investment Fund (EIF) on guarantees of bank loans lasting over three years granted to companies with less than 100 employees. The FCGM has provided EUR 29 million in counter guarantees.

The maximum counter-guarantee of each extended guarantee allowed by the FCGM is 80%. Whenever a mutual guarantee society is required to pay all or part of a guarantee, the FCGM pays the percentage of the sum paid equal to the percentage of the counter-guarantee.

Source : www.portugalglobal.pt, www.eif.org, Minister of Finances, Ministerial order no. 1354-A/99 (II Series), Decree-Law no. 229/98, of 22 July

Counter-guarantee systems are mostly located in developed countries. Applying counter-guarantees in developing countries has proven to be difficult due to inadequate financial development and legal conditions. An attempt was made in Chile to introduce counter-guarantees; however, the project was eventually abandoned. Recently, some insurance companies owned by banks in Latin America have begun providing counter-guarantees to their mother-banks, but such initiatives are new and their impact and feasibility are not yet certain (World Bank Partial Credit Guarantee Schemes Conference, 2008).

1.5.6 Involving donors, the public sector and the private sector

The primary role of the public sector in facilitating credit guarantee schemes is to create the appropriate regulatory environment. Public funding, especially initially, could also be considered e.g. as in Colombia or Chile. However, it is important that state subsidies interfere as little as possible with market mechanisms determining the supply and demand, and therefore the price and quantity, of credit. In many cases, national or regional governments have provided guarantee schemes with subsidies to target guarantees at SMEs or to help a guarantee fund expand operations. In other cases, governments have stepped in to provide initial capitalisation. While government initial capitalisation spreads risk between lenders, borrowers and the government, it can often also cloud the real operational costs. Many studies have shown that the role of the government should be limited to setting-up the appropriate legal environment and contributing to technical assistance. Subsidies should only be given over a short-term period, and the eventual aim of a guarantee scheme should be independence and self-sufficiency (Commission of the European Communities, 1991). The government should have a much more limited role in the management and risk assessment of the scheme (The World Bank, 2008).

Donors have also had an active role in funding guarantee schemes. Additionally, donors bring creditability to the scheme. Donors should, naturally, carefully examine guarantee schemes they are

looking to fund. Donors should also clearly define the responsibility of each actor and determine payment conditions based on key milestones and outputs to encourage adequate risk allocation.

Without the active involvement of the private sector, schemes are unlikely to succeed. Private sector funds are particularly important to ensure a fund's sustainability. In fact, banks and other private institutions can have a direct stake in a fund's capitalisation. Other options include private funding through equity. Mutual guarantee associations pool resources from their members. Private funds reduce the guarantee fund's dependency on public funds, which can sometimes be unstable. In many West African countries, public resources were not rapidly injected into the guarantee schemes. As a result, the schemes faced delays in disbursing their guarantees. Lenders were therefore reluctant to apply to the guarantee schemes. The end result was that many of the schemes, including those from Burkina Faso and Cote D'Ivoire, were forced to close (Balkenhol, 1990).

Box 9. Korean Scheme

Despite the success of the Korean Credit Guarantee Scheme, it maintains a default rate of 4 percent which is considered high by international standards. This is because the main goal of the scheme is to improve the credit environment for SMEs. Indeed, the fund provides credit to 230 SMEs and the total amount of credit guaranteed surpasses USD 33 million. The government only contributes USD 100 million to the scheme. The remaining USD 700 million in the scheme comes from commercial banks. The financial involvement of the private sector has enabled the fund to remain financially stable over time, despite its relatively high default rate.

In the 1980s while the Korean economy was growing rapidly, the fund issued many credit guarantees. However, in the late 1990s Korea experienced a very serious economic crisis and a financial downturn. To contribute to the normalisation of the financial market, the fund decided not to stop distributing guarantees. As a result, the default rate increased and still remains relatively high. However, the fund expects it to decrease over time – starting in the early 2000s the economy began improving and the fund quit expanding its credit portfolio; now it is putting more emphasis on improving the quality of the portfolio.

Source : World Bank Partial Credit Guarantee Schemes Conference, 2008

1.5.7 Regulatory and institutional framework

Many guarantee funds, especially mutual guarantee funds, have not had tremendous success in developing countries. Reasons for this include a weak legal framework and a non-competitive banking sector (Levitsky, 1993). For instance, in Senegal the National Craft Association (UNCM) and the Dakar Chamber of Commerce have both attempted to create a mutual guarantee scheme. However, minimum capital requirements prevented the funds from setting up shop – both funds aimed to operate on a smaller scale, and the minimum capital requirements were too high for them to either achieve or even need. The legal environment did allow the MGSs to establish as non-profit organisations, but most banks preferred dealing with a profit-making entity (Balkenhol, 1990). In contrast, a competitive banking sector and growing domestic capital market contributed to the success of the Chilean guarantee scheme.

Governments need to construct the conditions to enable the creation of MGSs and the growth of state-funded credit guarantee schemes. In particular, they need to minimise obstacles to their creation and growth and promote their use among the financial sector and the general public. A 2005 study by the London International Development Department identified a number of micro and macro factors that can contribute to the success of guarantee schemes. Included amongst their suggestions is the need for an open, competitive environment with independent banks and a framework that will support SME

creation and growth. Additionally, guarantees need to be regulated – however this is a slow process. For instance, Latin American countries only began regulating guarantees in the early 2000s.

Regulators can improve the environment for issuing guarantees in numerous ways. In particular, they can establish minimum capital requirements, the appropriate solvency ratio and transparency criteria. Such controls help improve banking sector confidence in the guarantee schemes and can help prevent any major crisis stemming from poorly issued guarantees. Additionally, these controls can contribute to higher liquidity among guarantee schemes, improving the ability of banks to recover the cost of their loans in instances of default.

One final question to consider is: who should take on the role of the regulator? Engaged external supervision can have a positive effect on the guarantee system, since it will reduce the risk of fund mismanagement. Guarantee scheme regulation contributes to the credibility of the schemes, and in the case when the scheme is supported by public resources, regulators can ensure the protection of those resources. In countries where the private financial market is well developed, regulation can be achieved, in part, with private sector actors. However, when this is not the case, public entities such as the central bank, should take over the task.

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