IFAD
Investing in rural people

Lessons learned

Loan Guarantee Funds

Inclusive rural financial services

The **Lessons Learned series** is prepared by the IFAD **Policy and Technical Advisory Division** and provides a compilation of past experiences relating to a particular topic and a reflection on evidence-based best practices and failures. "Best practices" refer to processes or methodologies that have been proven to produce good results and are thus recommended examples to be replicated.

These notes are "living" documents and will be updated periodically based on new experiences and feedback. If you have any comments or suggestions, please contact the originators.

Originators

Michael Hamp
Lead Technical Specialist, Inclusive Rural Financial Services
Policy and Technical Advisory Division
E-mail: m.hamp@ifad.org

Francesco Rispoli
Senior Technical Specialist, Inclusive Rural Financial Services
Policy and Technical Advisory Division
E-mail: f.rispoli@ifad.org

Jonathan Agwe
Senior Technical Specialist, Inclusive Rural Financial Services
Policy and Technical Advisory Division
E-mail: j.agwe@ifad.org

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Contact

Maria-Elena Mangiafico
Knowledge Management and Grants Officer
Policy and Technical Advisory Division
E-mail: m.mangiafico@ifad.org

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List of acronyms

ACGSF	Agricultural Credit Guarantee Scheme Fund (Nigeria)
CBN	Central Bank of Nigeria
CGF	credit guarantee fund
CGS	credit guarantee scheme
CPM	country programme management
CPMT	country programme management team
FIRA	Fideicomisos Instituidos en Relación con la Agricultura
FSP	financial service provider
LGF	loan guarantee fund
MFI	microfinance institution
MLI	member-lending institution
MSMEs	micro, small and medium-sized enterprises
SIDBI	Small Industries Development Bank of India
SMEs	small and medium-sized enterprises
USAID	United States Agency for International Development

Introduction

Financial services are critical for improved livelihoods in low-income and other least developed countries. IFAD has been implementing loan guarantee funds (LGFs) to promote access to micro, small and medium-sized enterprise (MSME) sectors, and only a limited number of which have been successful LGFs. This knowledge document summarizes both IFAD and non-IFAD experiences in implementing guarantees, highlighting the lessons learned and challenges experienced by the clients and financial institutions. It also outlines some strategies that service providers have used to overcome these challenges, allowing the microfinance sector to gain from lessons learned and best practices in lending to microenterprises.

Despite being critical and playing a key role in enterprise development, accessing finance is a challenging task for rural enterprises. Limited access is mainly associated with the high administrative costs of small-scale lending, the underdeveloped financial system, high risk perception of small enterprises and their lack of collateral, and asymmetric information. In order to lessen the financing constraints faced by MSMEs, IFAD and other actors have developed initiatives such as LGFs, which provide guarantees by covering a share of the default risk of the loan to individuals and groups that do not have access to credit.

This document highlights IFAD's and other partners' experiences with products, services, methods and approaches associated with LGFs. It will assist IFAD's country programme manager (CPM) to take up evidence-based good practices that can aid IFAD's thematic focus.

This document is based on consultations and a desk study drawn from IFAD's *Rural Finance Policy* (2009) and the *Decision Tools for Rural Finance* (2010). It provides country programme management teams (CPMTs), programme design teams (PDTs), and other practitioners with practical lessons and recommendations for scaling up and replicating successful LGFs. In addition to contributing to IFAD's branding, the product will consolidate and streamline the many different fragmented products and thereby enhance their effectiveness.

Context and challenges

Context

Smaller business enterprises in developing countries have difficulty in obtaining financial assistance from formal financial institutions, such as commercial banks, microfinance institutions (MFIs) and non-bank MFIs. In fact, studies have shown that most MSMEs start their lives without any institutional help. The entrepreneur usually obtains the small amount of finance he/she needs from his/her own savings or from his/her family. However, MSMEs find it difficult to grow without the opportunity to borrow from formal lending institutions. But lending institutions have a perceived high risk of lending to them and their inability to provide collateral has led to the introduction of credit guarantee schemes.

What is a loan guarantee fund (LGF)?

An LGF is a tool for risk mitigation and credit enhancement measures, operated at different levels to substitute part of the collateral required from a borrower. If the borrower fails to repay, the lender can resort to partial repayment from the guarantor. The main actors in LGFs are: (i) **the guarantor,** which can be a separate company or other form of distinct legal entity provided by the public sector or a donor; (ii) the **lender**, which can be any type of financial service provider (FSP) or a participant in agricultural value chains such as a buyer or seller of agricultural produce and commodities; and (iii) the **borrower**, which includes farmers and rural-based MSMEs.

What is the purpose of an LGF?

The LGF is an institution aimed at facilitating access by MSMEs to lending from formal financial institutions. LGFs do not extend any direct lending to enterprises; rather, their role is to ease the interaction between businesses and formal financial institutions. One of the main problems experienced by MSMEs relates to the difficulties encountered in mobilizing the collateral required by formal financial institutions, normally in the form of mortgages on real estate or pledges on machinery or other movable goods.[1] LGFs are established precisely with the objective of alleviating collateral requirements. In practice, credit guarantees issued by LGFs replace – or at least reduce – the need for other forms of guarantees and, therefore, make it possible for a larger number of MSMEs to access bank loans for the first time or to obtain larger loans. The relationships between an LGF, an MSME and a formal financial institution (e.g. a commercial bank) are illustrated in Figure 1.

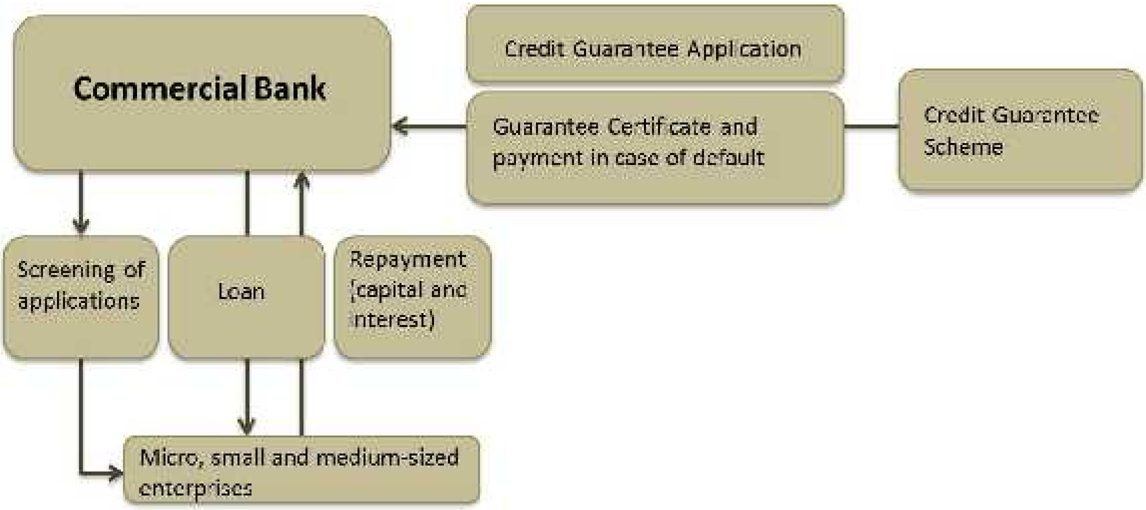

Figure 1. Relationships between a loan guarantee fund and a formal financial institution (wholesale schemes), and a loan guarantee fund and a micro, small and medium-sized enterprise (retail schemes)

Nature of credit guarantees

A credit guarantee is a commitment by the LGF (the “guarantor”) for the repayment of a loan received by an enterprise (the “borrower”) from a formal financial institution (the ‘lender’). LGFs can facilitate access to finance only if they are accepted as a valid substitute for other forms of collateral by formal financial institution. In the past, various types of credit guarantees were used in various countries. However, following the adoption and increasingly wide acceptance of the Basel II Accord, a more uniform approach has been implemented. In essence, in order to be recognized as a valid risk mitigating instrument, a credit guarantee must display certain features. It must be direct (represent a direct claim of the lender on the guarantor), explicit (address a specific exposure), unconditional (its payment is not submitted to conditions that are not under the control of the formal financial institution), irrevocable (cannot be cancelled by the guarantor unless the lender has failed to fulfil its obligations), explicitly documented and legally enforceable.

[1] There is substantial literature on credit guarantee schemes (CGSs). A slightly dated but still largely valid overview of the salient features of CGS can be found in the works of Levitsky (1997a and 1997b); more recent analyses include Green (2003); Bennett, Doran and Billington (2005); and Shim (2006). More recently, Zander, Miller and Mhlanga (2013) have taken a fresh look at the application and results of guarantee funds for agricultural and rural enterprise development.

Risk-sharing with formal financial institutions

Although established specifically to alleviate formal financial institutions' risks, LGFs typically do not cover the full value of loans. Indeed, leaving a substantial part of the risk to the formal financial institutions is a necessary condition to avoid "moral hazard" and opportunistic behaviour. In many countries, the coverage provided by credit guarantees typically ranges between 50 and 70 per cent, but lower and higher coverage rates are also found internationally (between 30 and 80 per cent), especially when LGFs are intended to pursue special policy objectives (e.g. the financing of start-ups or of firms based in economically depressed regions). The degree of coverage offered by LGFs is a crucially important variable because it may affect both the viability and the usefulness of guarantee schemes. While a low coverage reduces the scheme's exposure, formal financial institutions may not be fully satisfied and are likely to ask MSMEs for additional collateral, which reduces the positive impact ("additionality") of the scheme. A very high coverage may well provide adequate comfort to formal financial institutions but it could expose the scheme to excessively high losses.

Justification for an LGF

The absence of robust credit markets in developing countries is an impediment to sustained economic growth. Productive economic development is severely limited by the inability of entrepreneurs, small businesses and individuals to obtain loans. In contrast, there is widespread access to credit in most developed countries and it is relatively easy for entrepreneurs to get a loan to start a business, and for small businesses to get a loan to expand their operations. Thus, access to credit forms a vital part of an integrated approach to sustainable livelihoods and poverty alleviation, thereby offering a way to foster self-reliance.

Empirical studies demonstrate that credit plays a crucial role in economic growth. While developed countries enjoy higher growth rates partly because they have more vigorous credit markets, mainly from the bond markets and other significant non-bank sources of credit, least developed countries largely rely on formal financial institutions to source credit. However, MSMEs continue to face credit rationing by formal sector lenders. When they do obtain credit, it is often on comparatively disadvantageous terms. Thus, guarantees supported by donors have been recommended as a means of addressing these difficulties.

Advocates advance six arguments for involvement in developing and operating LGFs. Guarantees can: (i) overcome collateral constraints; (ii) offset the risks of lending to SMEs and microborrowers; (iii) address information constraints; (iv) compensate for low-profit margins; (v) modify intrinsic characteristics of small businesses and induce learning; and (vi) produce additionality.

Overall, LGFs increase the flow of funds into targeted groups. Different forms of LGFs are used to make lending attractive by sharing or absorbing the risks associated with lending to the target groups. However, LGFs have a cost, which is paid through the fees charged by LGF managers or subsidies from donors to implement the scheme. Globally, there is renewed interest in using LGFs to increase investment towards target groups and agro-industries that are deemed too risky for adequate financing without such risk-sharing incentives.

Institutional features[2]

Universally, guarantees constitute diverse and different institutional models. In most countries, LGFs are established on the initiative of governments and managed by ministries or government agencies (e.g. Britain's Credit Guarantee Scheme managed by the Debt Management Office) and the Guaranteed Loan Program managed by the United States Small Business Administration). In other countries, LGFs are initiated by the business community or as public-private partnerships involving government, the private sector, and/or the banking community ("hybrid schemes").

[2] For a well-documented typology of LGFs, see Beck, Klapper and Mendoza (2008).

Private and hybrid LGFs may take a wide range of legal forms. In Europe, most LGFs are structured as cooperatives or mutual societies. In other cases, they are structured as foundations or corporate bodies. Regardless of their nature, LGFs fulfil social roles and are not-for-profit entities. Even for corporate types, any profits made are not distributed but ploughed back into the scheme to strengthen its financial position. As a good practice, well-managed LGFs must strive for financial sustainability to avoid reliance on recurrent subsidies. This requires careful balancing between the drive to achieve a policy goal and the prudent behaviour typical of a financial institution.

Licensing and supervision

An LGF is subject to different licensing and supervision requirements, depending upon its nature. Public credit guarantee funds are often established on the basis of specific legislation. The credit guarantees issued by these LGFs can be qualified as "sovereign guarantees", engaging the government directly, and supervision is entrusted to the relevant government bodies. Private and hybrid schemes are typically regarded as non-bank financial institutions or, more rarely, as insurance schemes and their establishment is subject to licensing from central banks or from other financial sector regulators. Their operations are also supervised by regulatory bodies to ensure that operations are in line with basic principles of financial prudence. This typically involves setting up rules for provisioning and ceilings on the volume of guarantees that can be issued in relation to the capital. The fact that LGFs are subject to supervision from regulators reinforces the credibility of their commitments and it provides an additional advantage to formal financial institutions, which are normally not required to make provisions on the portions of loans supported by a credit guarantee issued by a duly licensed and supervised LGF.

Operational aspects

Volume of operations and multiplier

For any LGF, the level of activity is determined by the ratio between the LGF capital (equity and reserves) and the total amount of guarantees issued. This ratio is normally referred to as the "multiplier" or "leverage effect". The reciprocal of the multiplier is equivalent to the risk adjusted capital ratio ("solvency ratio") commonly used in the banking business, (i.e. the ratio between the risk-based capital and the risk-weighted assets). In developed countries, LGFs are often able to extend guarantees for a value that is 6 to 7 times greater than their capital but there are several cases of LGFs with multipliers of ten or more, such as France's Société de Caution Mutuelle Artisanale (SOCAMA) and Italy's Confidi.[3] In developing countries, operating conditions are obviously more difficult and it is advisable to adopt low multipliers, with a value of guarantees not greater than 3 to 5 times the value of the capital. In some extreme cases, the LGF multiplier is equal to 1, indicating that the LGF may extend guarantees only up to the value of their capital. However, in these cases, the capital of the LGF is de facto assimilated to cash collateral and the impact of the scheme is greatly reduced.[4] The magnitude of multiplier is typically one of the aspects supervised by regulatory bodies to prevent possible negative repercussions on the stability of the banking sector.

Operating modalities

From an operational point of view, LGFs can be subdivided into two broad categories: wholesale schemes and retail schemes. In the case of wholesale schemes, the relationship between the LGF and banks is regulated by a framework agreement and all lending transactions fulfilling certain criteria are automatically granted a credit guarantee. In this case, prospective borrowers approach the commercial bank directly and the LGF only performs ex-post checks to verify that the conditions specified in the framework agreement are implemented correctly by banks.

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[3] For details on the operations of European CGSs, refer to the website of the European Mutual Guarantee Association (AECM) www.aecm.be.

[4] An example of this approach is provided by the partial credit guarantee scheme recently proposed within the framework of the World Bank-funded Private Sector Competitiveness Project.

In the case of retail schemes, the LGF conducts its own due diligence on prospective MSME borrowers, complementing the analysis performed by the banks. In this case, prospective borrowers may indifferently approach the LGF or the bank and the credit guarantee is issued when both institutions have completed their respective due diligence process. In operational terms, wholesale schemes are comparatively less labour-intensive and, therefore, involve lower operating costs for the LGF. Retail schemes are more expensive to run but they can also add value to the screening process. In fact, due diligence conducted by the LGF typically involves reviewing different aspects from those analysed by banks, with the latter focusing primarily on traditional financial analysis and the former paying more attention to “intangible” factors (e.g. reputation and professionalism of borrower). The two approaches may coexist within the same LGF, with certain types of borrowers being treated through wholesale mechanisms and others through a retail approach.

Nature of lending transactions

A wide range of lending transactions can be assisted by the issuance of credit guarantees. Most LGFs provide credit guarantees for both short-term loans (typically used for working capital purposes) and medium- to long-term loans (to finance investments in fixed or movable assets). Depending on their specific mandate, LGFs may issue credit guarantees to a wide range of firms or only to some categories of borrowers, such as newly-established firms (i.e. start-ups) or to enterprises not exceeding a certain size threshold. Some LGFs have a sector orientation (e.g. they deal only with firms in retail trade, tourism or manufacturing) but most do not have any sector preference. In general, a substantial diversification across sectors and typologies of firms is preferable in order to reduce exposure to adverse developments in the economy. In a similar vein, LGFs, like many formal financial institutions, adopt ceilings regarding the exposure towards single borrowers in order to avoid an excessive concentration of risks.

Box 1: Comparing the first loss guarantee with the final loss-sharing guarantee

Consider the case of a medium-term loan worth US$100 whose purpose is to purchase a new piece of agroprocessing equipment. The loan is secured through: (i) a cash collateral of US$20; (ii) a pledge on the equipment; and (iii) a credit guarantee covering 70 per cent of the principal only. The borrower also signed a personal guarantee, whose value is deemed to be limited (more a moral obligation). Further, consider that the loan is defaulted during the second year, leaving an outstanding balance of US$80. The bank would immediately seize the cash collateral (a savings account); however, the equipment has disappeared and, therefore, no debt recovery is possible.

For the first loss, the calculations are as follows: the LGF pays 70 per cent of US$80 to the bank and, therefore, loses US$56. The bank loses only US$4, resulting from the difference between US$80 (the unpaid amount), the payment received from the LGF (US$56) and the cash collateral (US$20). For the final loss, the first step is to calculate the final loss, which is the difference between the unpaid amount (US$80) and the cash collateral (US$20) or US$60. Then, the LGF pays 70 per cent of the final loss to the bank and, therefore, loses US$42, and the bank loses US$18, resulting from the difference between US$60 (the final loss) and payment received from the LGF (US$42).

It is obvious that in the case of the final loss-sharing guarantee, the bank may have an incentive to pursue the defaulting borrower in order to try to recover something from his or her personal guarantee such as a car to be resold. This would also benefit the LGF, which would share whatever additional amount was recovered. In the case of the first loss guarantee, the bank may well decide that, given the minimal loss incurred, no additional recovery efforts are justified (although some banks may persist in pursuing defaulters for more collateral.

Loss-sharing mechanisms

As indicated above, LGFs are based on the principle of risk sharing with commercial financial institutions. However, depending on the specifics of the guarantee agreement, the share of losses borne by the two parties can significantly differ. In general, guarantees fall into two broad categories: the “first loss guarantee” (also defined as “joint and several guarantee with the borrower”) and the “final loss-sharing guarantee”. In the former, the LGF is required to pay the agreed percentage of the outstanding loan at the moment of the default. The remaining is covered by the lender, which can also retain the proceeds from the realization of any collateral that the defaulting borrower may have provided.

In the case of the latter, the LGF is required to pay the agreed percentage of the final loss (i.e. the outstanding loan balance at the moment of the default minus whatever amount has been recovered through the realization of collateral). The first loss mechanism is easier to implement, but when chances of recovery are significant, it may provide an excessively high level of protection to banks. Under the final loss-sharing guarantee mechanism, the LGF and formal financial institutions act as partners and losses are more equitably apportioned between the two parties (see Box 1).

Comparative analysis of credit guarantee fund projects

Worldwide, guarantees are characterized by few guarantee loan issuances since most schemes are terminated due to high costs and defaults with little or no reach and impact. There is also little additionality in terms of loans made, while few or no borrowers graduate to non-guaranteed lending. A key feature of guarantees is the uncertain or low sustainability due to a mismatch between high administrative costs and net claims paid out to formal financial institutions. The schemes are mainly publically capitalized with few private corporate systems.

Most guarantee funds are donor-driven with low visibility. Overall, their main objectives are to enhance finance for farmers and the rural sector, some of which are primarily commercial and focus on facilitating large international foreign direct investment inflows. Challenges include poor performance, poor implementation, high claim costs, poor repayments and high administrative costs. The case studies below highlight select samples of guarantees implemented in different parts of the world. They also highlight the different modalities, actions, challenges and impacts of the projects.

Case study 1: South America – Fideicomisos Instituidos en Relación con la Agricultura (FIRA), Mexico

Project overview. Founded in 1954, FIRA is a group of public trust funds supporting rural development. It is a publicly-owned and capitalized development financial institution operating as a second-tier institution with a single public administration. FIRA has loans, guarantees, capacity development and technical assistance for technology promotion and dissemination, and has its own network of branches in Mexico. It operates through specialized trust funds designed differently in line with different objectives and client requirements, and has over 100 offices in Mexico with a staff of 1,150. It targets communities with populations up to 50,000.

Objectives and outcomes. FIRA seeks to contribute to sustainable and competitive development of the Mexican agriculture, livestock, fishing, forestry and agribusiness sectors with innovative financial and technological services in order to improve the population’s quality of life. Specifically, it aims to: provide small-scale farmers access to formal sources of credit; strengthen the structure of small producers’ investment projects with training and technical assistance; increase credit fund flows through rural private financial intermediates; encourage private financial intermediaries to use their own resources to support producers with existing credit records; and ensure the long-term sustainability of FIRA.

Main actors. FIRA is operated under a single management, although it is a public sector organization. The board and management have enjoyed considerable continuity of leadership. The board is composed of representatives from the Federal Government, the Ministry of Finance, the Central Bank, commercial banks, the Mexican Bank Association, the Ministry of Agriculture and producer associations (composed of different types of agricultural producers in Mexico). The Ministry of Finance has the chair. The LGF is highly professional and technical, with independent management and decision-making, enabling it to avoid any interference.

Activities and process. FIRA's works are multi-purpose: loan funding, technical assistance and partial credit guarantees. Any business-related project in the rural sector in communities with fewer than 50,000 inhabitants can apply for FIRA coverage.

Challenges. Political interference, the inability of managers to counter the political interference and lack of transparency in the presentation of financial results of most guarantees, contributing to fragility and misuse.

Case study 2: Asia – Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE), India

Project overview. Designed by the Small Industries Development Bank of India (SIDBI), a state-owned commercial bank, it was expanded in 2007 to cover India's large regional rural banks, thereby increasing the system's volume and penetration into rural and agricultural areas. More than 110 member-lending institutions (MLIs) are registered with the CGTMSE.

Objectives and outcomes. The CGTMSE supports the development of the Indian agricultural sector, providing small farmers access to formal sources of credit.

Main actors. These include the Government of India's Ministry of Micro, Small and Medium Enterprises (80 per cent) and the SIDBI (20 per cent). It is managed from SIDBI's corporate office.

Activities and process. The LGF covers microenterprises with loans of up to US$8,152. For loans of up to US$6,929, 85 per cent of the default is covered; for loans up to US$81,520, 75 per cent is covered, while for those up to US$163,040, 50 per cent is covered. The guarantee starts from the date of payment of the guarantee fee and runs through the agreed tenure of the credit. For working capital, the guarantee cover is up to five years. In terms of guarantee fees, one-time guarantee fees of 1 per cent of the credit limit for credit facilities up to US$8,152 and 1.5 per cent for facilities above US$8,152 are charged. Annual service fees are 0.5 per cent for loans up to US$8,152 and 0.75 per cent for larger loans. On approval and disbursment of the loan, the MLI starts the registration process, which is online and generates a unique identity number for each borrower on acceptance by the CGTMSE. The MLI then pays the one-time guarantee fee against each borrower, which is transferred online to the CGTMSE within 30 days of loan disbursement. Overall, MLIs invoke a guarantee within a maximum of one year from the date of account non-performance.

Challenges. The biggest challenge is the slow and complicated claim settlement process, with a success rate of around 50 per cent. This is attributed to the complicated procedures for filing a lawsuit as a precondition for submission of a claim and the prescribed lock-in period of 18 months. The average time required to complete the settlement of an account (first instalment) is more than six months, which hinders the smooth functioning of the LGF.

Impacts. Nearly 70 per cent of guarantees are in the manufacturing sector, followed by the services sector (industry-related), textile products, food products and metal products.

Impacts. Reduced bank interest rate on guaranteed loans to clients; increased access to credit.

Case study 3: Africa – Agricultural Credit Guarantee Scheme Fund (ACGSF), Nigeria

Project overview. One of the oldest operating LGFs in developing economies, it was started in 1977 with 60 per cent funding from the Nigerian Government and 40 per cent from the Central Bank of Nigeria (CBN). The CBN also manages the system.

Objectives and outcomes. The ACGSF provides guarantees for loans to agricultural producers and processors. The model allows the farmer to jointly apply for a guarantee together with the lending bank.

Main actors. These include the Government of Nigeria (60 per cent) and CBN (40 per cent) and the ACGSF is managed by the CBN.

Activities and process. The ACGSF has very favourable terms and conditions, with 75 per cent coverage of the principal in case of default plus reimbursement of interest up to a level matching the interest income from non-due loans. The daily operations are under the CBN.

Challenges. These include: the slow settling of claims filed by banks, which leads to a drop in the number of banks participating in the guarantee; high administrative and operation costs (up to 90 per cent); limited field presence, linking only to the CBN's central and regional offices; and bad loans granted in its early years due to weaknesses in procedures for loan appraisal, monitoring and records of repayment. There are also low repayment rates and high defaults.

Case study 4: Eastern Europe – Rural Development Foundation (RDF), Estonia

Project overview. RDF is a state-capitalized system, operating as an individual loan guarantee system and collaborating with Estonian commercial banks. It was established through a merger of the Rural Life Credit Foundation and the Rural Credit Guarantee Fund. The merger aimed to adapt to the changing investment environment as Estonia evolved from a Soviet-based economy to a market-based one with privately-owned and managed farms.

Objectives and outcomes. The RDF supports credit access to agriculture and related investments along different agricultural, animal production and fishery value chains.

Main actors. These include the Government of Estonia and commercial banks. It is owned by the Government of Estonia and its equity capital belongs to the government. Management consists of a 16-member board comprising the public sector, banks and ministries representatives.

Activities and process. RDF operates as a multipurpose foundation supporting rural and agricultural development, which:

a) promotes investments in agricultural and rural areas

b) provides loans and guarantees as financing support to rural and agricultural entrepreneurs

c) offers training, capacity building and other types of technical assistance to end borrowers. Clients include SMEs and large-scale farmers and agro-enterprise owners, Savings and Credit Co-operatives (SACCOs) and non-profit community groups. The guarantees mitigate the high loan collateralization demanded by Estonian banks, which often reaches 120-150 per cent of the principal loan amount. The RDF provides guarantees up to 80 per cent of the loan, charging guarantee fees ranging from 0.5 to 6 per cent (but mostly between 3.8 and 4.6 per cent, depending on the risks). It continues to attract more clients with increasing volume of loans, attributed to the prudent management plus the multi-purpose set-up of the fund managing institution.

Challenges. Occasional political interference, bad loans, conflicting approaches by the board (composed of different sectors and allegiance).

Impacts. Improved loan repayment and uptake by clients; reduced bank interest rate on guaranteed loans to clients; and increased access to credit by clients.

Case study 5: Middle Europe – Sustainable Agriculture Guarantee Fund (SAGF), Netherlands

Project overview. It was initiated by Rabobank International (RI) in response to a call for public–private partnerships from Netherland's Ministry of Foreign Affairs. Partners include the Rabobank Foundation (RF), *Solidaridad* and Cordaid.

Main actors. These include supervisory board representatives from RI and the RF. A separate legal entity has been established – the Stichting Sustainable Agriculture Guarantee Fund, with a board of representatives from RI and the RF. A steering committee guides the board on policies, etc. Its members are representatives of the four founding partners. Day-to-day management is by RI's Structured Trade Finance Team under a service-level agreement with the SAGF.

Objectives and outcomes. The SAGF aims to enhance access to working capital credit (pre-export trade finance) for selected small- and medium-sized producers of sustainable agricultural products in developing countries, on commercial and sustainable terms, by issuing partial and conditional credit guarantees at affordable fees, preferably for local financial intermediaries. It aims to deepen the local financial sector by increasing access to financial services for those who previously had restricted or no access.

Activities and processes. It mainly provides credit guarantees to financial intermediaries that support countries' pre-financing of cooperatives and SMEs. Its aim is to establish long-term partnerships with participating financial institutions. It endeavours to organize cooperatives into organized member-based organizations, produce for and export to international markets on a fair trade basis and purchase raw materials from small producers on a fair trade basis. The SAGF uses public–private partnership to provide (partial) credit guarantees.

Challenges. Mainly organizational weaknesses within identified member organizations.

Impacts. Reduced bank interest rate on guaranteed loans to clients: short-term, pre-export financing is provided at acceptable commercial rates with less restrictive conditions (e.g. collateral requirements).

Increased access: During its first year of operations, the SAGF reached about 27,000 direct beneficiaries (individual producers) and 135,000 indirect beneficiaries (their family members).

Case study 6: United States of America – Development Credit Authority (DCA), United States Agency for International Development

Project overview. The DCA is owned by the United States Agency for International Development (USAID), with all of its activities managed by USAID's overseas missions, and is centrally priced and financially monitored (at USAID's Office of Development Credit in Washington, D.C.).

Objectives and outcomes. The DCA enables USAID missions to provide partial credit guarantees for private sector investments to reduce the risk associated with lending to new sectors or new borrowers. Guarantees stimulate development by increasing the flow of credit to areas that need it most.

Main actors. They are the USAID head office, the DCA and the USAID mission offices.

Activities and processes. It mainly provides partial guarantees to enhance credit with true risk sharing by private and public sector partners. The DCA works in countries and regions where USAID has an active presence. Eligible projects must have positive financial rates of return so that the loans can be repaid. USAID may decline to provide credit assistance where risk analysis of a specific project shows that the estimated risk is very high.

Challenges. There are problems in regions where USAID has little presence.

Impact. Increased access: an evaluation of USAID's Office of Development Credit found that between 2000 and 2009, USAID guarantees increased the Bank of Abyssinia's lending to the agricultural sector by 102 per cent. Once the bank realized the profitability of this sector, it continued to lend to 20 per cent of the formerly USAID-guaranteed borrowers without guarantees. Total lending by banks within Ethiopia to the agricultural sector increased from 8 per cent of outstanding loans in 2001 to 20 per cent in 2008.

Guaranteed loan use:

- Over the past ten years, the DCA has mobilized US$551 million of private sector credit in the agricultural sector at a cost of US$30 million to USAID.
- Guarantees for agriculture accounted for 39 per cent of the DCA's guarantee portfolio in 2011.

Lessons learned

LGFs appear to be an attractive form of support for small enterprise development in developing countries where non-availability of finance has been a serious constraint in developing the small business sector. However, guarantee schemes are only useful when the commercial banking system is ready to participate. Schemes in which the only participants are publicly funded, development finance institutions have little meaning, since ultimately the losses of these institutions must be made good from the public treasury.

The evidence from developed countries is that governments, the business community and the banking system must always assume some part of the risk. Guarantee schemes cannot and should not completely absolve banks from taking a normal level of risk because this is acceptable banking practice. Similarly, CGSs should not be expected to provide finance for projects of dubious viability. Credit guarantees backed by public funds should not eliminate the need for the lender to obtain some form of personal guarantee or collateral, where possible. An innovative way to lend would be to mandate that a percentage of the portfolio for all financial institutions must be lent to the rural/agricultural sector.

Design

Target group and impact. It emerges from evaluations (see ACCION et al., Measuring the Impact of Microfinance: Our Perspective, 1 April 2010) that LGFs have little or no impact on reducing interest rates for borrowers or total costs to borrowers.

Market distortions and shocks. A risk-management strategy should be set up that can deal with financial market shocks. This must include proper research on the value chains involved.

Increasing role of LGFs. LGFs and other risk-sharing systems are regaining prominence in rural finance due to excess liquidity in the banking system and lending restrictions to the SME sector.

Type/purpose of LGFs. Management is easier in a single-purpose LGF set-up. Clear apportioning of costs and staff time eases the management in a single-purpose guarantee.

Entry requirements. Stringent entry requirements hinder participation of private sector entrants into the guarantee market. In developing economies, there are very few private LGF agencies.

Implementation

Type of guarantees. Due to the generally small size of end loans in IFAD-supported projects, retail guarantee schemes are unlikely to become sustainable. Monitoring and initiating the guarantee is too staff-intensive in relation to the small volumes involved.

Instrument type. A first loss is detrimental to guarantors as they lead to quick fund depletion.

Coverage level. This should not exceed 50 per cent of total principal loan amount in the portfolio outstanding. The balance to be borne by the partnering financial institution ensures commitment and reduces the chances of misusing the CGF for a carefree covering of outstanding loan positions.

Pricing of guarantees: With smaller transactions, typical of smaller IFAD-type clients, pricing becomes an increasing challenge. Financial projections need to price guarantees realistically.

Diversification. The clustering of the portfolio and resulting covariance of risks pose strategic challenges, not just for financial institutions but also for CGFs, which assume the character of a financial institution with increasing maturity and retreat of public or donor funds. Portfolio diversification is always prudent for a guaranteed portfolio, as well as for an intermediary guarantee to an MFI that has previously only focused on micro trading and service loans.

Credit referencing. A well-functioning, national-level credit reference bureau is an effective deterrent against loan defaults, which improves the sustainability of loan portfolios and LGFs.

Risk threats. Guarantees face many risks, including market, weather and insurance risks.

Management efficiency. Efficient management of claims and the claims process is key to success.

Contract enforcement. There are problems with enforcing contracts among lenders, guarantors and borrowers due to weaknesses in financial regulatory framework and law enforcement systems.

Transparent activities. Successful LGFs exhibit consistency and transparent accounting. However, these features are often absent from LGFs worldwide.

Stakeholder trust. Building trust among stakeholders lowers the risks and appraisal cost.

Management experience. Most LGF management have no prior knowledge of the workings of partner lending institutions and/or the technical and financial profiles of end borrowers.

Risk sharing. Systems that are governed by considerations other than prudent and reasonable sharing of financial risk among partners in a credit contract are likely to fail.

Guarantee fees. High fee levels deter both borrowers and lenders; low fee levels deprive the LGF of a principal source of income. Fees should relate to expected defaults and overall interest rate levels in the relevant domestic financial sector.

Monitoring and evaluation

Management. Professional management of an LGF reduces the impact of the political demands.

Objectivity. For impact, LGFs must respond to specific and well-established demand and pursue clear and measurable objectives that can be monitored. The absence of these features indicates predominance of politics over professional fund management and viability.

Flexibility. Good systems need mechanisms for adjusting loan agreement with borrowers. Flexibility is also required in defining the access criteria for guaranteed lending facilities, the percentage of partial guarantee coverage, and the one-time and annual fees.

Monitoring and supervision. Proper monitoring and supervision systems, including automated MIS, play a key role in administration costs and thus, eventually, in its success or failure.

Collaboration. Successful systems require suitable collaborative relationships within 5-10 years.

Level of defaults: Defaults of the underlying guaranteed loan portfolio tend to be smaller in the initial stages of loan repayment. The claims then gradually increase with the growing age of the system. A fair assessment of LGF operations should not be made until at least five years after initiation.

Ownership. In developing economies, privately-owned and managed LGFs are rare.

Sustainability. LGF sustainability requires a long-term view accompanied by social objectives.

Funding levels. When an LGF is established, it should be fully funded to ensure sustainability.

Efficiency and information technology. Sustainability can be enhanced through efficiency gains on information technology and improved system design.

Follow-up and strategic recommendations

General recommendations

These recommendations are based on the overall guarantee working environment, arising arguments for and against LGFs, and current models available in the rural finance markets.

Promote rural finance in agricultural development. IFAD's CPM should emphasize the need to adopt the finance facilitation approach as a tool for poverty reduction. This will bring to the fore the importance of financial access, including the use of guarantees.

Engage the private sector actors. The CPM should continuously engage both the private sector actors and government institutions, including the formal financial institutions, credit bureaus and apex organizations involved in the provision of rural credit.

Promote savings and protect savers. The LGF organization should enable SME and microfinance intermediaries to engage in safe and sound deposit taking by issuing a guarantee to cover the depositors' funds held by the intermediary. The same application process as above would enable the guarantee organization to issue a financial guarantee that is, in effect, deposit insurance. The reporting requirements would likely be more stringent and the credit surveillance more intense.

Engage in policy reform towards effective guarantees. The CPM must continuously advocate for suitable policy instruments and environment so that incentives to lend are improved. The policy should be structured to incentivize lending to the SMEs.

Amend the banking rules. Some bank rules should be amended for developing countries with respect to the Basel Accord, since lending in developing countries is inherently riskier due to political and economic factors and should be supported by higher levels of capital beyond the 8 per cent requirement.

Reduce capital requirements. This reduction can be used as an incentive to encourage rural/agricultural lending by formal financial institutions, especially in developing countries.

Extend the term of lending. As is typical of developing countries, since most deposits are relatively short term, most lending is short term; therefore, there is need to lobby for policies that would permit banks to change and extend the terms of lending.

Use tax policy to promote lending. The results of guarantees can be enhanced by better tax policy. Formal financial institutions may be allowed accelerated write-offs of losses on some types of loans. When they suffer losses, they could write these losses off against profits in the year in which they occurred. Formal financial institutions would thus be able to deduct provisions from taxes. If the loan were subsequently recovered either totally or partially, the write-off would be reversed. Some tax revenues will be forgone as a result of accelerated write-off.

Design and implementation recommendations

Undertake a market assessment. As a best practice, the CPM must always undertake a market assessment of formal and informal sectors. This will assist in identifying the supply and demand levels and the type of products and support needed. The assessment should clearly establish the need for the intervention. If other service providers operate in the target area, there is a possibility of collaboration with these FSPs to expand to IFAD target areas so that the planned action is negotiated. If the assessment establishes sufficient demand and there is no alternative credit facilitation system, the design of the LGF should proceed.

Support capacity-building. Staff of the LGF should be targeted for capacity-building. Focus on bookkeeping, credit analysis and loan collection, among others. This should be supported by on-the-job training in good industry practices. Support technical assistance to develop LGF products. Due to the minimal experience by IFAD in guarantee schemes, it would be appropriate to bring in an external technical expert to develop products, services and delivery mechanisms that are effective and sustainable.

Support development of a management information system (MIS). The design and commissioning of an appropriate, sustainable and user-friendly MIS should be supported.

Provide continuous support and supervision. After the initial training to staff, ongoing support and regular supervision are critical.

Assess and support regulatory and oversight agencies. Depending on the choice of the local FSPs, apex organization and regulators, CPMs need to assess the strengths and weaknesses of these entities, including their willingness and ability to perform their roles effectively, and their legality and compliance with common regulations.

Support regular audits. Internal auditors should be identified and trained, and external audits supported.

Support exchange visits. Exchange visits should be part of other experienced and successful guarantee programmes, which will be assimilated as proven lessons learned and best practices.

Provide long-term sustainability and an exit strategy. This could be achieved through linkages to second-tier apex organizations, which would provide the continuation of the LGF system beyond the IFAD support. The linkage may be through federations, non-governmental organizations (NGOs) or other experienced FSPs.

Develop a user-friendly yet effective monitoring and evaluation (M&E) system. This must be carried out at the design stage and all indicators must be effectively tracked. The M&E system is, therefore, a management tool for corrective actions by management.

Recommendations based on lessons learned

These recommendations seek to incorporate positive lessons learned into future practice, suggesting parallel projects, activities and processes to which the lessons learned could be applied.

Lessons learned	Recommendation
Target group and impact: From evaluations by ACCION, LGFs have little or no impact on reducing interest rates for borrowers or total costs to borrowers.	Strike a balance between interest rate levels in the cost of lending and total costs to borrowers.
Loan guarantees sustainability requires a long-term view and an institutional focus accompanied by social objectives.	Design long-term LGFs with social objectives.
Design phase	
Market distortions and shocks: An LGF distorts local markets.	Provide risk-mitigation strategies to market shocks.
Entry barriers: Inhibitive requirements deter prospective private entrants from the guarantee market.	Review entry requirements.
Type of guarantees: Because of the generally small size of end loans in IFAD-supported projects, individual guarantee schemes are unlikely to become sustainable.	Design portfolio guarantees for the parts of an FSP portfolio that reaches IFAD's target groups or wholesale guarantees for FSPs.

Lessons learned	Recommendation
Pricing of guarantees: Pricing of the smaller IFAD type of clients is a challenge.	Financial projections need to price guarantees realistically.
A well-functioning, national-level credit reference bureau is an effective deterrent against loan defaults, thus improving the sustainability of loans/LGFs.	Strengthen the formation of credible national-level credit reference bureaus. Work with these bureaus during design and implementation.
Building trust among stakeholders in an LGF reduces risks and appraisal costs.	Ensure that LGF partners are transparent and fair.
High fee levels deter borrowers and lenders; low fee levels deprive guarantee funds of a principal source of income.	Design fees relevant to the domestic financial sector.
Flexibility is needed in defining access criteria for LGFs and the one-time and annual fees.	Ensure that programme design is flexible, especially in eligibility criteria.
An LGF should be fully funded to ensure sustainability and meet growth requirements.	Seek and provide adequate funding sources.
Implementation phase	
Diversification: Clustering of portfolio and resulting covariance of risks pose challenges not just for FSPs but also for LGFs.	Consider strategic portfolio diversification for loan guarantees.
Risk threats: Guarantees face several risks, including market, weather and insurance risks.	Design risk mitigation strategies in the implementation of LGFs.
A successful LGF has consistent/transparent accounting.	Provide for consistent and transparent accounting systems.
Steep entry barriers discourage private entrants into the guarantee market.	Promote flexible access conditions for private parties.
Professional management of an LGF reduces the impact of the political demands.	Ensure the right professionals are recruited to manage LGFs by public vetting of appointed team.
Systems must have mechanisms for adjusting loan agreements with lenders and borrowers.	Design programmes that are flexible, especially on repayments terms.
SMEs are not profitable due to low productivity, lack of managerial capacity and inefficient business models, etc.	Provide capacity-building for targeted value chains.
Defaults on loan portfolios tend to be smaller in the initial stages of loan repayment. Claims then gradually increase with the age of the LGF.	Set up more stringent loan recovery systems throughout the life of the business during the entire loan payback period.

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International Fund for Agricultural Development
Via Paolo di Dono, 44 - 00142 Rome, Italy
Tel: +39 06 54591 - Fax: +39 06 5043463
E-mail: ifad@ifad.org
www.ifad.org
www.ruralpovertyportal.org
ifad-un.blogspot.com
www.facebook.com/ifad
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