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**Credit Guarantee Schemes for Small Enterprises:
An Effective Instrument
to Promote Private Sector-Led Growth?**

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**Credit Guarantee Schemes for Small Enterprises:
An Effective Instrument to Promote Private Sector-Led Growth?**

by

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UNITED NATIONS INDUSTRIAL DEVELOPMENT ORGANIZATION
Small and Medium Enterprises Branch
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ACRONYMS

ACSIC	Asian Credit Supplementation Institution Federation
AECM	Association Européenne du Cautionnement Mutuel (European Mutual Guarantee Association)
ALEGA	Asociación Latinoamericana de Entidades de Garantía (Latin American Association of Guarantee Agencies)
ASKRINDO	Ansuransi Kredit Indonesia
BBMKB	Besluit Borgstelling voor Midden- en Kleinbedrijven (Dutch state guarantee scheme)
BDPME	Banque du Développement pour les Petites et Moyennes Entreprises (French development bank)
CEFP	Cottage Enterprise Financing Project (Philippine mutual guarantee association)
CFD	Corporación Financiera de Desarrollo (Colombian development bank)
CGC	Credit Guarantee Corporation Malaysia Berhad
CIC	Small Business Credit Insurance Corporation (Japan)
DICCG	Deposit Insurance and Credit Guarantee Corporation (India)
EBRD	European Bank for Reconstruction and Development
EIF	European Investment Fund
EU	European Union
EUR	Euro
FNG	Fondo Nacional de Garantías (Colombian guarantee scheme)
FOGABA	Fondo de Garantías Buenos Aires (Argentinean guarantee scheme)
FOGAPI	Fondo de Garantía para la Pequeña Empresa (Peruvian guarantee scheme)
FUNDES	Fundación para el Desarrollo Sostenible (Swiss-based NGO administering guarantee schemes)
HGA	Hrvatska Garancijska Agencija (Croatian Guarantee Association)
IIRD	Indian Institute for Rural Development
ILO	International Labour Organization
ITF	International Guarantee Fund (administered by RAFAD)
KCGF	Korean Credit Guarantee Fund
KFW	Kreditanstalt für Wiederaufbau (German development bank)
KredEx	Estonian Credit and Export Guarantee Fund
LGS	Loan Guarantee Scheme (British guarantee scheme)
LPG	Loan Portfolio Guarantee Programme (Programme administered by USAID)
MCGFS	Mutual Credit Guarantee Fund Scheme (UNIDO-promoted mutual guarantee associations in India)
MGA	Mutual Guarantee Association

NGO	Non-Governmental Organization
OECD	Organisation for Economic Co-operation and Development
PHARE	Poland Hungary Assistance for Reconstruction of the Economy
RAFAD	Recherches et Applications de Financements Alternatifs du Développement (Swiss-based NGO administering guarantee schemes)
RCGF	Rural Credit Guarantee Fund (Romania)
REGAR	Red Iberoamericana de Garantías (Ibero-American Guarantee Network)
RLGF	Romanian Loan Guarantee Fund
SBA	Small Business Administration (USA)
SBLA	Small Business Loans Act (Canada)
SEBRAE	Serviço Brasileiro de Apoio às Micro e Pequenas Empresas (Brazilian Micro and Small Business Support Service)
SICGF	Small Industry Credit Guarantee Fund (Thailand)
SIDBI	Small Industries Development Bank of India
SMBCGF	Small and Medium Business Credit Guarantee Fund (Taiwan)
SMEs	Small and Medium-Sized Enterprises
TASSSMA	Tiny and Small Shoe Makers Association (Ambur, India)
UNDP	United Nations Development Programme
UNIDO	United Nations Industrial Development Organization
USAID	United States Agency for International Development

EXECUTIVE SUMMARY

Micro, small and medium enterprises are frequently hailed as the backbone of the economy. There is widespread consensus on their significant contribution to economic growth, employment creation, social cohesion, poverty alleviation and local and regional development. However, a lack of formal credit often hinders small firms from developing their potential¹. The credit limitation of small enterprises is mainly due to the high administrative costs of small-scale lending, asymmetric information, the high risk attributed to small firms, and their lack of collateral. The fact that small enterprises often receive less finance or face worse conditions than larger firms can put them at a competitive disadvantage and will seriously harm long-term growth and development through under-investment, a waste of entrepreneurial resources, a reduction of productivity and a lower growth rate.

In order to address this problem, various government and donor-initiatives have emerged in industrial as well as developing and emerging economies, notably credit guarantee schemes. Dating back to the 19th and early 20th century in European countries, credit guarantees were implemented in developing and emerging economies throughout the late 20th century as a measure to promote private sector-led growth. Today, over 2250 schemes exist in various forms in almost 100 countries. The major types of guarantee systems which can be identified are mutual guarantee associations, publicly operated national schemes, corporate associations, schemes arising from bilateral or multilateral co-operation, and schemes operated by NGOs.

This paper attempts to determine whether credit guarantee schemes are efficient and effective instruments to promote private sector-led growth. Credit guarantee schemes aim to diminish the risk incurred by lenders and are mainly a reaction to small firms' lack of collateral. However, they also have the potential to reduce the costs of small-scale lending and to improve the information available on borrowers. They thus not only enable small firms to access formal credit, but can also improve the terms of a loan. Credit guarantee schemes therefore assist small enterprises to obtain finance for working capital, investment and/or leasing purposes at reasonable conditions. This enables firms to improve their competitiveness and to extend their economic activity. Guarantee schemes' potential to promote small enterprises and economic growth, however, is not restricted to their role in enabling investments in physical capital alone. By providing additional services such as

¹ For the sake of simplicity, the terms "small firms", "small enterprises" and "small businesses" will be used to encompass the categories of micro, small and medium enterprises.

consulting and training to entrepreneurs, guarantee schemes also contribute to the accumulation of human capital. Targeting enterprises in rural areas can assist regional development and help decrease rural-urban migration. In developing and emerging economies in particular, schemes may support the formalization of micro enterprises and improve the opportunities of marginalized groups, thus assisting in poverty alleviation and the reduction of social and political tensions.

The failure of several credit guarantee schemes in the 1980s has led to great controversy about their justification and effectiveness. The criticism levelled against guarantee schemes is therefore explored. It is found that the weaknesses of early guarantee schemes can largely be avoided through proper design and private sector involvement. Good practices are identified, which may serve as guidelines in the design and implementation of schemes. These include organizational aspects such as a scheme's status as a government institution or a legally separate entity, the type and source of funds, the number and qualification of staff and management, the degree of centralisation, and the existence or non-existence of a profit motive. Furthermore, the procedure of extending the guarantees, the eligibility criteria that borrowers must satisfy and the type of finance targeted are decisive factors of a scheme's efficiency. Additional aspects which can greatly influence a scheme's performance are its marketing efforts, the distribution of risk, additional services offered, the procedures used to screen and monitor borrowers, the level of fees, the credibility of the guarantor in handling claims and the relations between guarantor and lender. The level of leverage a scheme achieves and the existence or non-existence of counter-guarantees will have an effect on its sustainability and thus on its potential to assist a large number of firms. A scheme's viability is further enhanced through proper regulation and supervision.

This paper stresses the need for comprehensive evaluations of credit guarantee schemes, to account for the public and private resources used. There are a number of evaluations of individual guarantee schemes, but these are often limited in scope. This is mainly due to the high costs and methodological problems involved in comprehensive studies. Nevertheless, schemes should continuously attempt to monitor their efficiency and to assess their impact on borrowers and lenders. To the extent that a guarantee scheme is able to adapt according to the evaluation results, such assessments will ensure good performance and improve the scheme's potential to improve small firms' access to finance.

Due to their inherent difference from other types of guarantee schemes, an entire chapter is devoted to mutual guarantee associations. These are solidarity groups formed by small enterprises without access to credit, and have, on average, a better performance record than public guarantee schemes. These associations have the potential to overcome adverse selection and moral hazard in lending and to act as driving forces behind entrepreneurial development. UNIDO, within the scope of its Cluster Development Programme, has been active in promoting mutual guarantee associations in two Indian artisan clusters.

In conclusion, it is argued that well-implemented credit guarantee schemes can improve small enterprises' access to credit and assist the integration of small enterprises in the formal financial market. This will ultimately translate into improved business performance

and job creation. However, in spite of their potential as development engines, it remains doubtful if credit guarantee schemes are indeed efficient mechanisms to promote private sector-led growth. Critics do not see sufficient reason for government intervention by means of publicly-funded schemes and question the cost-effectiveness of such schemes. Firstly, it is doubtful whether guarantee schemes are a first-best measure to address the market failures identified in the credit market. Establishing credit bureaus and initiating legal reforms may be better suited to overcome asymmetric information and small firms' difficulties in pledging their property as collateral. Secondly, it is unclear if guarantee schemes accomplish the financial sector changes as well as the financial and economic additionality they are designed to achieve. Little conclusive evidence on the benefits of guarantee schemes exists. Many schemes, particularly in developing and emerging economies, have achieved only limited outreach. On the other hand, some well-established schemes both in emerging and industrialised countries have been able to reach a large number of small firms.

Most of the literature on credit guarantee schemes focuses on small and medium enterprises, with some experts asserting that guarantee schemes are not the proper mechanism to target micro enterprises. This paper includes micro enterprises in the analysis, as they represent the single largest strata of firms in most economies and as many existing schemes do in fact target micro enterprises.

CHAPTER I:

Introduction²

Restricted access to credit is one of the main challenges faced by small enterprises and can ultimately have an adverse effect on economic growth and overall welfare. This chapter identifies the high administrative costs involved, asymmetric information, high risk perception and lack of collateral as the main disincentives for banks to engage in small-scale lending. It is found that due to the existence of market failures in the credit market, government intervention may be justified.

A. Small enterprises and Their Access to Finance

Although there is wide debate about the exact role of small enterprises in driving economic change, most authors agree that due to their flexibility, their innovative capacities and their role in strengthening competition and social cohesion, small firms perform vital productivity- and growth-enhancing functions in the economy. In order to make use of their potential, these firms need to be provided with an enabling environment, which encompasses the access to capital. However, one of the greatest obstacles to the entry, development and growth of small firms in industrialised and emerging economies is access to formal finance.

Depending on their size and environment, enterprises see access to formal finance as more or less challenging. Whereas young and small firms are usually deprived of credit in all surroundings, medium enterprises in industrialised countries are likely to suffer from an insufficient volume of credit or unsatisfactory conditions. Their counterparts in developing and emerging economies may, however, be disadvantaged both in access to credit and in the terms of loans.

Table 1 gives an overview of the sources of finance used by small, medium and large enterprises for investment. Whereas all types of firms mostly rely on retained earnings, small and medium enterprises are more dependent on these funds than are large firms. Compared with larger enterprises, small firms are restricted in their access to commercial bank and government funds although the latter play only a marginal role for them. As a consequence of their disadvantaged status, small and, to a lesser degree medium enterprises, seek recourse to (short-term) informal finance.

² This publication draws partly on an unpublished paper prepared by the author for the OECD (OECD, 2003).

Table 1 Share of Investment Financed through Different Sources, by Enterprise Type (in %)

	Small ¹	Medium-Sized ¹	Large ¹
Retained Earnings	53.4	55.1	44.6
Commercial Banks	12.7	17.8	28.8
Government	0.7	5.6	5.6
Informal Sources ²	15.6	3.0	1.1
Other Sources ³	17.7	18.4	20.0
Number of Observations	890	1020	311

Note: Countries included in the analysis are Argentina, Bangladesh, Belarus, Bolivia, Botswana, Brazil, Cambodia, Chile, Croatia, Czech Republic, Egypt, Estonia, Ghana, Guatemala, Honduras, India, Indonesia, Lithuania, Malawi, Malaysia, Mexico, Moldova, Nigeria, Panama, Peru, Philippines, Poland, Portugal, Republic of Korea, Romania, Russia, Senegal, Slovenia, Thailand, Trinidad, Turkey, Venezuela and Zambia.

¹Small enterprises have fewer than 50 employees, medium-sized enterprises between 50 and 200, and large enterprises over 200.

²Informal sources include family and friends, money lenders, and other traditional or informal sources. ³Other sources include supplier credit, leasing arrangements, equity and sale of stock, and other unspecified sources.

Source: Clarke, Cull & Martinez Peria (2001).

The larger the firm, the easier is access to bank credit and the better are the loan conditions it receives. Loans to large customers are encouraged by banks through employee incentive schemes, which are often based on the amount of credit granted. Additionally, the vast array of alternatives to domestic bank loans available to large firms, e.g. recourse to capital or international financial markets, augments their bargaining power at the time of negotiating a loan contract.

In contrast to large firms, small enterprises are often unable to cover their financing needs. The fact that small businesses receive less finance or face worse conditions than larger firms puts them at a competitive disadvantage. Without sufficient long-term finance, small firms are unable to expand their businesses and to introduce productivity enhancing technology. This will have adverse consequences for the competitiveness of the sector and the economy as a whole.

In developing countries, the financing problems of small enterprises are exacerbated. Comparing the ratios of credit provided by the financial system and non-bank financial intermediaries to the private sector in industrial and emerging economies can give an indication of the extent of financial repression (Holden, 1997). Whereas domestic credit to the private sector exceeded GDP by far in countries such as Germany (118.2%), the United Kingdom (123.4%) and the United States (145.3%), it represented only 26% in India and was as low as 5.9% in Uganda or 2.1% in Sierra Leone (World Bank, 2001)³. According to Pombo and Herrero (2001) up to 80% of investment demand by SMEs remains unsatisfied in some Latin American and African countries. For micro enterprises, this figure rises to 95%.

³ Domestic credit to the private sector refers to financial resources provided to the private sector - such as through loans, purchases of non-equity securities, and trade credits and other accounts receivable - that establish a claim for repayment (World Bank, 2001).

The limited access of small enterprises to formal credit in developing and emerging economies is largely due to the relatively underdeveloped nature of the financial system, the lack of liquidity, and inexperience in small-scale lending in many of these countries. Bank branches outside the capital cities frequently provide only cash and do not have the authority to make loans, leaving small enterprises in rural areas unproportionally disadvantaged. If commercial banks do extend credit to small firms, it may take up to several months to process applications.

B. Disincentives to Small-Scale Lending

Banks advance four main reasons for their reluctance to extend credit to small enterprises:

- High administrative costs of small-scale lending,
- Asymmetric information,
- High risk perception,
- Lack of collateral.

Although the reasons apply to industrial as well as developing and emerging economies, they tend to be more significant in the latter.

i. High Administrative Costs of Small-Scale Lending

Since most of the administrative costs of lending are fixed, i.e. independent of the size of the administered loan, economies of scale arise: the larger the loan, the lower the per unit costs of extending credit. Furthermore, administrative costs also include information-gathering costs, e.g. visiting borrowers, analysing their applications and monitoring their loans. For a number of reasons, these costs tend to be higher for small than for large firms. Small enterprises are often located away from the main urban centres, their accounting skills and standards are usually lower, and banks lack experience in servicing them. In the case of developing and emerging economies, these difficulties, and therefore the costs involved, are multiplied.

Evidence from the Caja Social, a Colombian financial institution granting small loans, suggests that the costs of administering small loans range from 11% to 13% of the portfolio's value per year (Gudger, 1997). Transaction costs for servicing small firms not yet integrated into the formal financial market rise to a multiple. This implies that the margin over cost of funds (i.e. the interest rate) must be at least as high, even without accounting for loan losses.

ii. Asymmetric Information

A prerequisite for the efficient allocation of resources by market forces is that all participants share the same relevant information. This is not the case in financial markets.

Borrowers will always know more about the viability of their projects and their ability and willingness to repay than lenders. The lender is thus faced with uncertainty both with respect to the expected rates of return of the project he is financing and with respect to the integrity of the borrower. This uncertainty increases with the length of the loan. Borrowers face difficulties in transmitting information about their projects to lenders, as lenders will suspect them of underestimating the risks of failure. The problem of asymmetric information will be more acute for small businesses than for larger ones because of lower information standards and the greater variability of risk: small, privately-owned firms face no legal reporting requirements and are more vulnerable than large firms.

Due to asymmetric information, it is impossible to accurately distinguish between “good” and “bad” borrowers. The two main problems associated with asymmetric information are adverse selection and moral hazard, both of which may affect the quality of the loan. Adverse selection refers to the fact that the probability of default is increasing with the interest rate: the quality of the borrower pool worsens as the cost of borrowing rises. A higher interest rate will attract risky borrowers and drive out good borrowers for two reasons. Firstly, worse risks are willing to borrow at higher interest rates, because they know that their repayment probability is low. Secondly, if riskier projects are associated with higher returns, a rise in the interest rate will drive out low-risk projects as borrowers try to compensate for the higher cost of the loan by earning a higher return with a risky project. An optimal interest rate may therefore exist, beyond which additional loans are not made available despite excess demand. Consequently, a backward-bending credit supply curve and equilibrium credit rationing will exist because raising the interest rate above the optimal level would lower banks’ profits as the amount of risky projects in their portfolio rises (Stiglitz & Weiss, 1981). Small firms are more likely to be rationed because they are seen as particularly risky. Although they might be willing to pay more to compensate for this additional risk, the banks will refuse to raise the interest rate sufficiently to equate supply and demand⁴.

Moral hazard refers to a situation in which an agent (the borrower) takes an action that adversely affects the return to the principal (the lender). It occurs if the parties involved have diverging interests and the action taken by the agent cannot be monitored accurately by the principal. A borrower may, for example, be tempted to exert less effort or to secretly switch to riskier projects in order to increase his return. Because of a higher probability of default, the return to the bank will be reduced. Banks can resort to two methods to reduce moral hazard: (1) by making it profitable to tell the truth, e.g. through the promise of renewed credit in the future and/or (2) by including penalties for low effort levels, e.g. collateral which is lost if the firm becomes insolvent. Due to information imperfections and costly control mechanisms, the superior selection criteria based on cash-flow projections is thus often abandoned in favour of loan selection according to firm-size and collateral. This results in suboptimal allocation of credit since some firms

⁴ Despite the wide acceptance of adverse selection and its implications for the credit market, some criticism exists. By slightly altering the assumptions made by Stiglitz and Weiss, De Meza and Webb (1987) find opposite results, i.e. markets for loans characterised by credit surplus rather than deficiency.

with profitable projects may be deprived of credit simply because of their size or insufficient collateral.

iii. High Risk Perception

Commercial banks tend to impute a high risk to small enterprises and are therefore reluctant to extend credit to them. Due to their small size and inherent vulnerability to market fluctuations, the mortality rates of small enterprises are relatively high. These firms are, by their very nature, often relatively young and consequently lack a financial history and a track-record of profitable projects. In addition, organizational and administrative deficiencies, lower quality management and a lack of appropriate accounting systems may compromise the accessibility and reliability of information from small firms on their repayment capacity. Also, small loans to industry are often classified as personal loans. Banks therefore may lack concrete figures of how profitable loans to small enterprises are and what costs they entail. Finally, the relative labour-intensity of small firms implies a high debt-to-asset ratio if loans are made. The associated vulnerability and lack of sufficient and adequate collateral further limits the amount of finance that banks are willing to grant them.

In developing and emerging economies, the disadvantage of small firms with regard to risk-perception is aggravated by a number of factors. Many small enterprises have evolved in the informal economy, making it difficult for them to document their business history and demonstrate their economic potential. Additionally, small entrepreneurs in emerging economies are typically less skilled in book-keeping, marketing and management than their counterparts in industrial countries, adding to the risk perception with regard to their projects. This is exacerbated by inadequate legal frameworks which make the enforcement of contracts difficult for lenders.

iv. Lack of Collateral

Under first-best conditions, the net present value of a firm's profit stream should determine the amount of credit it receives. However, due to the existence of asymmetric information, banks base their lending decisions on the amount of collateral available. Collateral acts as a screening device and reduces the risk of lending for commercial banks. By pledging his assets, a borrower signals the quality of his project and his intention to repay. In the case of default, collateral serves to put the lender into a privileged position with regard to other creditors. Banks' acceptance of a certain asset as collateral depends on the present and anticipated transaction costs involved. These include the costs of verifying ownership of assets, determining their value and marketability as well as their appropriability and access in comparison to other lenders. Despite its advantages for lenders, the policy of demanding collateral often inhibits small borrowers with viable projects from attaining credit. Their lack of adequate collateral arises both from their labour-intensity and from the low value of their machinery and property.

In many emerging economies, problems in the legal system make debt enforcement and the use of collateral difficult. Potential borrowers may be unable to pledge some of their assets as collateral because they are unable to prove they own them due to inappropriately

defined property rights. Additionally, moveable assets such as machinery or livestock, which constitute a large share of small firms' assets, are often excluded as collateral. Since movable property may be difficult to store, its value declines over time (equipment depreciates and livestock dies) and inefficient secondary markets lead to high liquidation costs, lenders typically demand real estate as collateral instead. This, however, is likely to belong to large firms or rich landowners.

Whereas in many industrial countries, a firm's inventories can be used as collateral by making a floating pledge of a specific value, this is not possible in most parts of Latin America (Holden, 1997). In these countries, the law stipulates that each and every piece of property pledged must be identified and only the original goods in the pledge may be seized in the case of default. Should the borrower have sold the collateral, lenders are not able to seize the proceeds of the sale in many countries. Verifying that an asset has not already been pledged is complicated by multiple registries in which a pledge may be recorded.

In the event of default, foreclosing on collateral will usually involve costly litigation, which may exceed the value of small loans. Alternatively, it may be socially and politically difficult to seize collateral of low-income entrepreneurs. Doran and Levitsky (1997) note that banks trying to foreclose on collateral in Indonesia can be subjected to procedural lawsuits and that pledging assets for more than one debt is permitted under the legal system. Laws designed to protect borrowers thus inhibit their access to credit in the first place.

Oehring (1995b) observes that while European banks generally require 100% to 120% security, the figure lies between 180% and 300% in Latin America. Many potential borrowers in emerging economies are therefore driven out of the market for credit all together. The assets they possess do not satisfy the marketability criterion of collateral and can thus not be pledged. Their machinery may be outdated and/or personal assets valuable to them are not accepted by the banks because they may be of little use to others. Reputation is often seen as a substitute for collateral. However, small firms' lack of collateral prevents them from establishing a reputation since the initial credit cannot be attained.

C. Market Failures and the Case for Government Intervention

There is wide debate whether the difficulties faced by small enterprises in obtaining access to credit justify government intervention. Whereas some experts see the inequity in the conditions under which small firms receive loans as sufficient reason for intervention, most economists hold that a justification must be based on market failures. There is controversy whether these imperfections exist in the credit market. A Roundtable on Credit Guarantee Schemes under the auspices of the Inter-American Development Bank in 1996, for example, failed to reach agreement on the issue. On balance, however, the conditions justifying government intervention seem to be fulfilled, as asymmetric information, imperfect competition and externalities can be identified as factors affecting the credit market.

i. Imperfections in the Credit Market and Externalities

The fact that many potential small business borrowers with economically and financially sound projects do not have sufficient collateral is not a market imperfection in itself. However, the main underlying reason why banks do not charge interest rates high enough to cover their costs is asymmetric information. Asymmetric information does constitute a market failure and is of central importance in credit as opposed to commodity markets. In the latter, the seller of a physical good is indifferent about the use to which it is put by the buyer. The seller of a financial service (i.e. the lender), however, has a vital interest in what the buyer (i.e. the borrower) does with the borrowed money, since this determines the likelihood of repayment. In contrast to commodity markets, credit markets also involve a time dimension in that the good purchased (i.e. credit) will only be fully repaid in the future. Since future contingencies cannot be foreseen and banks fear adverse selection and moral hazard, collateral is given a higher priority than the viability of the project. This policy leads to suboptimal allocation of funds.

The allocation problem is further aggravated by the fact that credit markets do not always fit the model of competitive markets. Due to the long-term nature of successful financial relationships, good loan conditions can be attained by building a reputation with a certain lender. Borrowers will therefore remain with their lenders, even if lower cost loans may at times be available elsewhere. Untested borrowers, especially those unable to provide sufficient collateral, are unlikely to receive funds at all. Additionally, legal requirements governing the creation of banks act as barriers to entry and may lead to oligopolies in the banking sector. There is thus no economic pressure on banks to develop loans to small enterprises as a new business segment, to increase their market share by decreasing interest rates, or to cut costs. Banks therefore choose to focus on large and more profitable clients.

Information externalities may also play a role in the credit market and may have negative consequences for small firms seeking loans. Although ratings for individual borrowers would significantly reduce the high risk attributed to small enterprises, banks are reluctant to introduce them. Since information (in this case on the projects and reliability of potential borrowers) is costly to produce, but almost costless to disseminate, banks cannot exclude the free-riding of other financial institutions. They will thus have little incentive to produce information, and their risk perception of small firms will not be reduced⁵. A similar logic applies to banks' reluctance to develop lending technologies suitable for small-scale loans. Since innovations may be copied by others, banks are unlikely to pioneer new lending procedures to reduce costs. Without government intervention encouraging the production, but not the dissemination, of information and new lending procedures, the risk factor and high transaction costs will continue to be a deterrent to small business lending.

⁵ In some countries, e.g. Germany, private initiatives have emerged which collect information on borrowers behind on their payments and on the financial soundness of firms.

ii. Intervention in the Credit Market

Due to the market imperfections described above, a case can be made for government intervention in the market for credit to small firms. The major political motivation for intervention is the important socio-economic role played by small enterprises. In light of growing unemployment numbers, governments have come to realise that the development of the small-firm sector does not only sustain employment but can also lead to considerable net employment creation. Governments worldwide have thus mostly abandoned the post World War II doctrine of supporting large enterprises and have turned to small firms instead.

Traditional approaches to the development of small enterprises have concentrated on directed and subsidised credit programmes. They have led to distortions in the financial markets by lowering the interest rate artificially and thus encouraging excessive use of capital, fostering slow repayment and allowing unprofitable firms to survive (Hallberg, [1999]). They have substituted for markets rather than dealing with the underlying problems restricting small firms' access to the formal credit market: the high administrative costs of small-scale lending, asymmetric information, high risk perception, and lack of collateral.

Hallberg ([1999], p.12) notes that

[a] market-oriented strategy for improving small firm access to financing focuses on reducing the risks and transaction costs associated with this segment of the market, strengthening the capacity of financial institutions to serve smaller clients, and increasing competitive pressure in financial markets. The aim is to increase the number of financial institutions that find lending to SMEs to be profitable, and therefore sustainable.

Although Hallberg sees guarantee schemes as traditional approaches to small firm development, it will be seen below that they can fulfil the conditions of a market-oriented strategy. If properly designed and implemented, they have the potential to assist the integration of small enterprises in the formal financial market, which will ultimately translate into job creation and enhanced economic growth.

CHAPTER II:

Credit Guarantee Schemes in Practice

This chapter identifies financial and economic additionality as well as a reduction in banks' risk perception of small enterprises as the main objectives of guarantee schemes. Based on the operator of the scheme and the operational method used, a typology of credit guarantee schemes is developed. It is shown that there is wide historical and geographical variation among guarantee schemes and the criticism that has been levelled against guarantee schemes is examined. The concluding section highlights the emergence of a new generation of guarantee schemes, which address the problems and criticism of earlier schemes.

A. Objectives

Guarantee schemes are designed to alleviate the problems faced by small-scale borrowers seeking credit and to achieve financial and, ultimately, economic additionality. They aim to offset situations in which borrowers with an equal probability of default have an unequal probability of obtaining credit since some have insufficient collateral. Whereas in most cases guarantee schemes focus on access to credit as such (especially for micro and small enterprises and in developing and emerging economies), they may also aim to improve the terms of a loan (mostly in the case of medium enterprises that already have access to formal credit). At the same time, guarantee schemes pursue social goals, such as reducing social tensions, empowering marginalized groups or assisting post-war reconstruction. Whereas in industrialised countries they are mostly seen as correctors of the market for credit, they are also applied as development instruments in emerging economies.

i. Financial and Economic Additionality

Guarantee schemes aim to achieve financial and, ultimately, economic additionality⁶. Financial additionality primarily refers to an increase in commercial bank loans to credible clients (small enterprises) who previously did not have access to credit as a result of lacking or inadequate collateral. However, by reducing the risk to banks and assisting firms to establish a repayment reputation, guarantee schemes also achieve financial

⁶ The *Loan Guarantee Scheme* in the UK further distinguishes between partial and temporal additionality: in the absence of the scheme, some projects would be partially, but not fully, funded and others would be eventually financed, but are delayed (OECD, 2000).

additionality in terms of an enlargement of the loan size, a longer repayment period, a decrease in the interest rate or in the collateral demanded as well as an increase in the amount of borrowers who graduated to non-guaranteed borrowing. More rapid loan processing is also considered as additionality if it is due to improved lending techniques adopted as a result of banks' experience with guaranteed borrowers.

Beyond the goal of financial additionality, guarantee schemes ultimately aim at achieving economic additionality, i.e. improvements in income and quality of life of the borrowers' households, an increase in the amount of commercial and economic activity in terms of employment, sales, new products developed, competitiveness, productivity and economic growth.

ii. Financial Sector Changes

In order to achieve additionality, guarantee schemes need to effect changes in the banking sector. Firstly, through a learning process, lenders must gradually shift their risk perception of small firms. Guarantees enable lenders to learn about the creditworthiness of borrowers without incurring the initial risk involved. First-time borrowers and those perceived as excessively risky are thus assisted to establish a repayment reputation, which can act as a substitute for collateral. With time, they will be able to "graduate" to non-guaranteed loans. Secondly, guarantee schemes are intended to develop institutional capacity in small business lending. By gaining experience with small firm lending, banks are likely to develop ways to lower transaction costs and thus to make credit extension to small firms more profitable. Finally, guarantee schemes may introduce an element of competition into the banking sector if small banks participating in the scheme are able to strengthen their position by developing lending to small enterprises as a new profitable market segment.

B. Typology of Guarantee Schemes

There is some debate on whether credit guarantees are a form of collateral or insurance (Meyer & Nagarajan, 1996a). Credit guarantees can be seen as a type of collateral because they provide the lender with a security which can be liquidated in the case of default. Just as collateral, they intend to signal the borrower's creditworthiness and reduce the risk incurred by the lender. In contrast to collateral, however, they do not represent an effective threat mechanism for the lender since they are provided by an external agency. Alternatively, credit guarantees may be seen as a type of insurance whereby the guarantor insures lenders against default of borrowers and receives a fee for this service. However, credit guarantees do not insure the borrower who, under normal circumstances, loses the assets he has pledged in the case of default. Credit guarantees are thus an incomplete form of both collateral and insurance.

Linguistic problems and the existence of hybrid forms of guarantee schemes make their systematic classification difficult. Depending on the environment, the same operational formulas have different names. In English speaking countries, the term "guarantee fund" refers to any guarantee agency whose guarantees are backed by a fixed fund, whether

operated publicly, privately or by an NGO. In Brazil, by contrast, the *Fundo de Aval SEBRAE* is operated by the development agency for small enterprises and, as a state-operated agency, corresponds to what would be denominated as a “guarantee programme” or “scheme” in English speaking environments⁷ (Pombo & Herrero, 2001).

The main point of distinction of guarantee systems should thus not be the terminology used but the operator of the scheme. Five major types of guarantee systems can be identified: mutual guarantee associations, publicly operated national schemes, corporate schemes, those arising from bilateral or multilateral co-operation, and schemes operated by NGOs⁸. The identified systems can further be subdivided according to the operational mechanism used (i.e. selective, portfolio or intermediary approach, which will be described in section v below).

No matter which operational form for the scheme is adopted, it is essential that there be a good and stable relationship between all parties involved (i.e. guarantor, financial institutions enterprises and the public sector). Even in cases where the public sector is not the majority owner of the guarantee scheme, it plays a central role in determining the legislation covering the scheme, possible tax exemptions and supervision.

i. Mutual Guarantee Associations

Mutual guarantee associations are private societies formed by potential borrowers with limited access to bank loans. Depending on the environment they are known as *mutual guarantee associations/societies/funds* (anglophone countries), *sociétés de cautionnement mutuel* (francophone countries) or *sociedades de garantía recíproca* (Hispanic countries). These types of guarantee agencies are particularly frequent in Europe and South America. Co-operation of the individual associations on an international level takes place through the *Association Européenne du Cautionnement Mutuel* (AECM)⁹ and the *Asociación Latinoamericana de Entidades de Garantía* (ALEGA) as well as the *Red Iberoamericana de Garantías* (REGAR). Since mutual guarantee agencies differ considerably from all other forms of credit guarantees, they will be discussed in greater detail in chapter 5.

ii. Public Guarantee Schemes

State guarantee schemes are run either by an administrative unit of the government (e.g. development agencies, ministries, the central bank or publicly-owned banks) or by a legally separate credit guarantee organization. Resources usually take the form of periodic appropriations, i.e. continued subsidies, or of a fixed fund (see chapter 3, section B). Public guarantee schemes still represent the majority of guarantee schemes worldwide. Unlike profit-oriented private guarantors, the main rationale behind public schemes is the state’s expectation that better access to finance for small firms will lead to the creation of

⁷ In line with most authors, this paper uses the term “guarantee scheme” to designate guarantee systems in general, regardless of the operator.

⁸ Export guarantees, which provide guarantees against the specific risks inherent in exporting, are outside the scope of this paper. For more information on export guarantees and export credit agencies, see for example ITC (1998).

⁹ AECM also counts several public guarantee schemes among its members.

new enterprises, new employment possibilities, and ultimately a higher rate of economic growth.

iii. Corporate Guarantee Schemes

In recent years, efforts have been made to encourage private participation in guarantee schemes. Many schemes are now corporately managed by participating banks, chambers of commerce, or by the entrepreneurs themselves. Funds come from initial capital provided by the private owners or from public sources as well as donor contributions. Governments thus often continue to exert influence on these schemes, for example by reserving the right to appoint part of the management. Some authors maintain that private guarantors cannot compete with the government in establishing confidence in their ability to pay claims. A well-endowed fund is therefore a prerequisite to create credibility.

iv. International Schemes

Some schemes have come into existence as a form of multilateral or bilateral development cooperation. In addition to providing the funding, the various organizations often provide technical assistance in designing and implementing the scheme. In all cases, a local organization is needed to assist in the implementation process. This may be a public institution (e.g. a ministry, a national development organization, or the central bank), financial institutions, private associations, or NGOs. Pombo and Herrero (2001) distinguish three types of organizations which have developed credit guarantee schemes: organizations of multilateral cooperation operating at a global level (e.g. UNIDO, UNDP and ILO), those operating at a regional level (e.g. the African and Asian development banks and the European Investment Fund), and organizations of bilateral development cooperation¹⁰. An example of each type of scheme is described in Box 1. UNIDO's experience with the development of mutual guarantee associations in India is described extensively in chapter 5.

Many international NGOs have also been active in setting up and financing guarantee schemes. The best-known ones include those of ACCION International, FUNDES and RAFAD, all of which have a large part of their operations in Latin America. Box 2 gives an overview of these schemes.

¹⁰ Pombo and Herrero (2001) identify the development cooperation agencies of Austria, Canada, France, Germany, Luxemburg, Spain, Switzerland, the United Kingdom and the United States as bilateral entities providing technical assistance and/or funding for guarantee schemes.

Box 1 Multi- and Bilateral Cooperation in Guarantee Schemes

The International Labour Organization (ILO) has been active in assisting the implementation of guarantee schemes in various countries. In order to avoid the bureaucratic procedures encountered in many of the public schemes in recipient countries, the ILO opted for decentralised schemes, which are independently managed by local NGOs or private voluntary organizations. The success rate has been remarkable, with default rates not surpassing 2.25% within the first four years of operations and some cases of 100% recovery. The ILO also has an assistance programme for the implementation and development of mutual guarantee associations in several African countries and Jordan (Pombo & Herrero, 2001).

The European Investment Fund (EIF), created in 1994 and jointly owned by the European Investment Bank (60%), the European Commission (30%) and about 20 European financial institutions (10%), is an example of multilateral organizations extending guarantees at a regional level. The EIF manages two EU guarantee programmes: the *Growth and Environment Scheme* and the *SME Guarantee Facility*. The former offers guarantees to financial institutions which grant loans for financing environmentally friendly investments to small European firms (with up to 100 employees). The latter is part of the EU's Growth and Employment Initiative and provides guarantees to financial institutions as well as counter-guarantees to existing schemes which extend guarantees to small firms. It consists of four special windows, namely Loan Guarantees, Micro-credit Guarantees, Equity Guarantees and ICT Loan Guarantees. For these purposes the EIF manages a fund of EUR 198 million on a trust basis for the European Commission (European Investment Fund, 2001).

USAID's *Loan Portfolio Guarantee Scheme (LPG)* is a unique type of guarantee scheme in that no national guarantee facilities exist. In contrast to other donor-supported schemes, it does not provide funding to a particular organization but is a series of international bilateral commercial guarantee agreements between USAID's Centre for Growth and privately-owned commercial banks in about twenty countries. The arrangements stipulate a maximum guarantee facility, lasting initially for 3-5 years but renewable, out of which banks can allocate risks from their portfolio of eligible loans and receive a coverage of 50% (70% for loans to micro enterprises). A mandatory bank training element is part of the agreement. Usage rates vary among and within countries. According to USAID, the leverage achieved is \$25 in lending per \$1 of appropriation. The office in Washington, D.C. collects all fees and pays out claims. Congressional budget allocations determine the capacity of the scheme (Doran & Levitsky, 1997).

Many international NGOs have also been active in setting up and financing guarantee schemes. The best-known ones include those of ACCION International, FUNDES and RAFAD, all of which have a large part of their operations in Latin America. Box 2 gives an overview of these schemes.

Box 2 **NGO-Operated Guarantee Schemes**

ACCION International created the Latin American *Bridge Fund* in 1984 as one of the first guarantee funds available for micro finance. The fund is deposited in a US bank which offers irrevocable standby letters of credit to ACCION's affiliates in Latin America. This enables them to receive credit from local banks and use it to on-lend to micro enterprises. The fund is financed from loans provided (at below the market rate) by individuals, churches, foundations, institutions and government agencies. To protect lenders to the fund from potential losses, a loan loss reserve of at least 5% of outstanding guarantees has been created. However, the prime measure of risk reduction is seen to be responsible management of the fund as well as stringent screening and monitoring policies (Otero, 2002).

FUNDES (*Fundación para el Desarrollo Sostenible*) is a Swiss-based international fund which operates loan guarantees in Bolivia, Chile, Colombia, Costa Rica, Panama and Guatemala. As a general rule, 50% of the foundation's capital is donated by companies in the country in question and the other 50% comes from companies in Switzerland. Occasionally, the foundation receives contributions from development organizations. The FUNDES guarantee package includes a guarantee coverage of 50% as well as support services to lenders and borrowers. The average annual loss rate was kept at 0.7% until 1995, when it rose to 4.1% as a result of losses in Guatemala and Colombia. During the political and economic crisis in Panama in the late 1980s, FUNDES experienced guarantee schemes' dependence on the economic and political climate first hand (Oehring, 1995b, 1997; Pombo & Herrero, 2001).

Another Swiss-based NGO is RAFAD (*Recherches et Applications de Financements Alternatifs du Développement*). Among its various activities, RAFAD assists the setting up of guarantee funds and, similar to ACCION, provides international guarantees to enable development organizations in Africa and Latin America access to bank credits. RAFAD cooperates with the ILO on a project involving several NGO-managed guarantee funds and operates the *International Guarantee Fund* (ITF). Shareholders of the ITF are various international donors and institutions as well as local partners in developing countries. Since the beneficiaries of the guarantees also contribute to the fund, it can be said that the ITF is based on the mutual guarantee model. In 1999, the value of the funds of RAFAD and the ITF amounted to more than \$2.1 million together. Between 1988 and 1999, the average default rate was 3.5%. RAFAD receives a counter-guarantee for its operations from the Swiss development assistance agency (Doran & Levitsky, 1997; Pombo & Herrero, 2001).

v. Operational Mechanism of Guarantee Extension

In addition to the operator, guarantee schemes can be classified according to the method used in guarantee extension. Three basic operational mechanisms exist: the selective, portfolio (global) and intermediary approach. In contrast to the selective and portfolio approach (which will be explained in detail in chapter 3, section F), the intermediary mechanism is distinct in that it introduces an additional actor in the process and is most often used by NGOs to target micro enterprises specifically. Since this paper discusses credit guarantees for micro, small and medium enterprises in general and the vast majority of schemes do not follow the intermediary approach, it will concentrate on those schemes applying either the selective or the portfolio approach in the remainder.

Intermediary models are based on the assumption that there is a large distance between banks and businesses seeking credit which can only be overcome through the help of an intermediary. In this model, the guarantor (often an international organization) offers a guarantee enabling a local organization (the intermediary) to receive bank loans, which are subsequently used for on-lending to (micro) enterprises. There is thus no loan contract between the lender and the ultimate borrower. The intermediary performs the debt

collection function and repays the loans to the bank. This is the model successfully adopted by ACCION's *Bridge Fund*.

C. Historical and Regional Overview¹¹

The importance of guarantee schemes has varied significantly over time and place. The first predecessors of guarantee associations, the Brussels Credit Union and the Banque Populaire in France, were founded in the 1840s. Today over 2250 schemes exist in almost 100 countries. The largest and best-established schemes are encountered in OECD countries and Asia.

In Europe, mutual guarantee associations are the predominant organizations administering credit guarantees. They emerged in the early twentieth century in countries with a strong tradition of guild or craft organization such as France (1917), Belgium (1929), and Germany (1930). The associations experienced a revival in the reconstruction period after World War II and were successfully exported to other European countries with the most recent forms of mutual guarantee associations established in Spain (1978), Portugal (1994) and Greece (1995) (Lloréns, 1997).

In Asia, guarantee schemes date back to the late 1930s (Hatakeyama, Yamamori & Nakamura, 1997). The first guarantee scheme was established in 1937 in Tokyo, modelled on the mutual guarantee corporations encountered in Germany. Between 1947 and 1949, further guarantee corporations were established in five other cities and in each of the forty-seven Japanese prefectures. In 1960, the *Indian Credit Guarantee Corporation Ltd.* was established and in 1961, the Republic of Korea introduced the *Korean Credit Guarantee Fund* (then known as the *Credit Guarantee Reserve Fund*), thus becoming the second East-Asian country to establish a guarantee scheme. In the early 1970s, the governments of Indonesia (1971), Malaysia (1972), Taiwan (1974), and Nepal (1974) introduced their schemes, followed by the Philippines (1981), Thailand (1991), and China (1991).

In Anglophone North America, guarantee schemes have been operated by public agencies since the mid-twentieth century. The Canadian *Small Business Loans Act (SBLA)*, established in 1961, and the US *Small Business Administration (SBA)*, created in 1953, are the main guarantee agencies in the region. Due to their vast resources, both are able to reach a large number of small enterprises in their respective countries. Whereas the Canadian scheme has \$10 billion in outstanding guarantees, the equivalent for the SBA is \$40 billion.

In Latin America, the first large-scale trial of guarantee schemes took place in the mid-1980s¹². The results were not encouraging. A majority of the schemes failed because their funds' capital was depleted by high claims rates or poor investment decisions and because

¹¹ This section mainly draws on Pombo and Herrero (2001).

¹² In Mexico, a guarantee scheme had already been established in 1953, which was discontinued in 1989.

banks became increasingly unwilling to make use of the schemes. This was mostly due to excessively strict guarantee conditions and a lack of confidence in the schemes' willingness to honour claims. Corruption and political influence in decisions also played a role in undermining some schemes (Levitsky, 1997c).

In Africa, there are large differences between schemes operating in North African and sub-Saharan countries. Whereas the schemes in the North are fairly successful, their counterparts in sub-Saharan countries, with the exception of South Africa, experienced setbacks similar to those in Latin America. The best-developed African schemes are encountered in Morocco, Egypt and South Africa.

In Australia, no well-developed credit guarantee scheme exists. However, there have been several initiatives to establish guarantee schemes within the last decade.

Despite the negative experiences with guarantee schemes in developing countries in the 1980s, there was a resurgence of guarantee schemes in the mid-1990s. Whereas newly established schemes in Africa are mostly based on government or multilateral initiatives, those in South America have tended to adopt the mutual approach¹³. Throughout the 1990s, many public guarantee schemes were also established in Central and Eastern Europe as well as in the Former Soviet Republics. Many of these benefited from the financial and technical assistance of the European Union, the EBRD and USAID. In addition to the establishment of these schemes, a considerable amount of legislation regulating their operations has been passed in recent years.

D. Criticism of Guarantee Schemes

The failure of credit guarantee schemes in the 1980s has led to great controversy about their justification and effectiveness. Critics do not see sufficient reason for government intervention by means of publicly-funded schemes and question the cost-effectiveness of such schemes.

i. Government Intervention in Guarantee Schemes

It has been criticised that market failures are often not at the core of official justifications of schemes (Vogel & Adams, 1997). Instead, the main argument advanced by government officials in favour of guarantees is the assertion (without explaining the underlying reasons) that small businesses are faced with a systematic lack of finance and that the economy in general would benefit from increased small-firm access to credit. The loan guarantee programmes of Canada, Japan, the United Kingdom and the United States, for example, do not mention credit market imperfections as a rationale for their programmes. Their motive is simply to facilitate access to debt capital for small firms (Riding, 1997). Critics argue that governments' arguments are not a sufficient justification for the use of public fund required to sustain guarantee schemes. Furthermore, they contend that a continued flow of government subsidies, often disguised by the provision of free or low

¹³ Of the South American countries with guarantee schemes, public guarantee schemes predominate only in Brazil, Chile, and Paraguay (Pombo & Herrero, 2001).

cost facilities and services as well as secondment of staff from other government departments, will provide little incentive for guarantee schemes to reduce costs and increase efficiency. In the critics' view, a cost effective and more efficient way to improve small enterprises' access to credit is the training of bank personnel in small business lending. This would eventually lead to a reduction of administrative costs and the risk perception.

Even if imperfections in the market for credit are identified, a justification of guarantee schemes must show that they are the most suitable form of intervention to address the root causes behind small firms' difficulties in accessing finance. To address the problem of asymmetric information and to reduce the transaction costs as well as the uncertainty surrounding repeat lending, credit bureaus are seen as superior to credit guarantee schemes. If the financial system is inefficient and a non-repayment culture exists, installing a guarantee scheme may do more harm than good. Many critics also fear that guarantee schemes will be used as substitutes for structural reforms, which they see as the first-best solution to the problem of small firms' inability to access formal finance. For example, if collateralisation of the types of assets that small enterprises own is systematically prevented due to deficiencies in the legal system, a reform of the legal system is more appropriate than an intervention in the market for credit.

ii. Questionable Benefits of Guarantee Schemes

Opponents of guarantee schemes criticise that, in spite of their poor track record in developing and emerging economies, guarantee schemes continue to be recommended and implemented by governments and donors. Critics consider credit insurance functions as part of lenders' normal operations since banks shift and reduce risk by diversification and by including a reserve for bad debts in their interest rate calculation. These critics therefore propose to "leave banking to the banks" (Seibel, 1995).

Critics suspect that a majority of the borrowers receiving guarantees would have received credit without the scheme. Since additionality cannot be determined accurately (see chapter 4), little empirical evidence exists whether guarantee schemes actually achieve their objective. The fact that few evaluations of the true benefits of credit guarantee schemes exist, should be a sufficient reason to be sceptical about the use of public funds for this purpose. Vogel and Adams (1997) identify two types of substitution effects which may arise from guarantee schemes and which are likely to lead to an overestimation of additionality by the guarantee organization: intraportfolio substitution and interlender substitution. The former arises when a lender transfers some or all of the qualifying portion of its existing loan portfolio to the guarantee programme and then expands his lending in nontargeted areas. This type of substitution is likely to occur if lenders are under political pressure to make use of the guarantee scheme. Interlender substitution refers to a situation where small enterprises serviced by other banks are captured by those banks operating under a guarantee scheme. In these situations, little net changes of the credit extended to the target sector are likely to occur in the credit market as a whole and additionality will be overestimated.

It is also questioned whether lender behaviour can truly be altered by guarantee schemes. Critics believe that banks will take what they can get to reduce their risks but will not be willing to continue servicing small enterprises once the guarantee is withdrawn. Even in cases in which experiences with small-scale borrowers are positive, the high administrative costs of small-scale loans will act as a deterrent to continue servicing small firms. In emerging and developing countries, the main problem is to achieve commercial banks' participation in the scheme in the first place. Banks mistrust schemes and fear bureaucratic delays in processing loans. The experience of many guarantee schemes in developing countries gives them no reason to be less sceptical. Due to bank scepticism and a subsequent lack of lender participation, the proportion of bank loans subject to guarantees is fairly small in all countries.

iii. Costs of Guarantee Schemes

Besides the questionable benefits of credit guarantees, opponents object to the high costs they entail. Three types of costs can be distinguished: the set-up costs, the costs of funding the guarantees and the additional costs incurred by the financial system to run and to participate in the guarantee programme (Vogel & Adams, 1997). It is these latter costs which have been most heavily criticised.

The introduction of an additional institution in the credit market is likely to impose superfluous costs on both lenders and borrowers. When risk is shared between the lender and the guarantee agency, certain functions such as the screening of borrowers and documentation may be duplicated, unless responsibilities are clearly divided between the parties. For the lender, making claims on defaulted loans will imply additional transaction costs, especially if disputes over the settlement are involved. For the borrower, costs are increased if he must deal with two entities (the lender and the guarantor) instead of only one. Furthermore, the processing time for the loan may increase since the lender must wait for an approval of the guaranteeing agency. Finally, because guarantee fees are usually passed on to the borrower, the interest rate may also rise above the non-guarantee level.

Critics assert that credit guarantee schemes will lead to additional distortions in the credit market. Assuming that the amount of credit available at any time is fixed, the extra transaction costs involved in making more credit available to small than to large borrowers will lead to a reduction of overall welfare. Additionally, guarantees may help inefficient firms to survive. If lenders restrict their limited funds to guaranteed borrowers, those without a guarantee may be crowded out. Depending on the use to which both types of borrowers put their funds, this may result in a reduction of overall welfare. Non-guaranteed borrowers may also be negatively affected if they have to compete with guaranteed borrowers who have access to a larger amount of credit, possibly at lower interest rates.

Another argument against guarantee schemes is that they cannot decrease, and are even likely to introduce an additional level, of asymmetric information in the credit market. This is possible since all three parties involved have differing objectives and actions cannot be monitored perfectly. Guarantee schemes, especially state-operated and/or donor-funded ones, may increase moral hazard of both borrowers and lenders. Borrowers

know that their loans are guaranteed and therefore do not feel obligated to repay them. They know that the losses will be absorbed by the state-run guarantee agency. Banks, on the other hand, might be more lax in their screening and monitoring functions due to the reduction of risk entailed by a guarantee. When the borrower is behind on his payments, they are likely to call in the guarantee without exerting effort to collect the outstanding part of the loan. Adverse selection may also be introduced if the purchaser of a guarantee (i.e. the lender) knows more than the guarantor about the risks of individual loans and therefore only purchases guarantees for those loans of greater than average risk. If the passing on of the fee results in a rise of the interest rate, adverse selection of borrowers may also occur. By introducing this second level of risk, the total risk of lending may actually rise with a guarantee.

E. New Generation of Guarantee Schemes

Many of the criticisms outlined above were valid for the early centrally administered public guarantee schemes prevalent in developing and emerging economies until the early 1990s. The failure of many of these schemes lent plausibility to the contention that guarantee schemes are ineffective and a waste of public funds. These failures, however, were mostly due to deficiencies in the wider institutional environment. The schemes were politicised and neglected financial criteria or economic conditions affecting the borrower's ability to repay. They were thus often faced with a large number of claims. Payment was restricted to avoid decapitalisation, which led to mistrust and the reluctance of lenders to participate in the scheme. Alternatively, the schemes failed to generate a sufficient volume of business in the first place.

The shortcomings of guarantee schemes in the past have led to a revision of many design features encountered in earlier schemes concerning organizational and operational issues. The private sector has been increasingly involved in funding and participating in the management of schemes. Incentives for moral hazard of borrowers and lenders have been reduced while safeguarding the attractiveness of the scheme to participants. Attempts have been made to improve the relations between lender and guarantor and to introduce proper regulation and supervision. All revisions ultimately aimed at enhancing the efficiency and sustainability of guarantee schemes which were deemed necessary in view of the continued reluctance of banks to extend credit to small firms. It is true that a guarantee scheme will most likely increase total lending transaction costs by creating its own operating costs. Nevertheless, the new generation of guarantee schemes shows that through proper design, these additional costs can be minimised.

CHAPTER III:

Design And Implementation of Guarantee Schemes¹⁴

While guarantee schemes need to be tailored to local realities, it is essential to learn from past experience and identify good practices that can serve as guidelines for the design and implementation of future schemes. This chapter examines a wide range of organizational and operational issues and identifies good practice indicators. Some of the recommendations outlined below might seem trivial at first sight; the high failure rate of early schemes, however, shows that they were often overlooked in the past.

The following organizational aspects must be considered during the design phase of a credit guarantee scheme: its status as a government institution or a legally separate entity, the type and source of funds, the number and qualification of staff and management, the degree of centralisation, and the existence or non-existence of a profit motive.

A guarantee scheme can only function efficiently if the road to its objectives is clearly defined. The procedure of extending the guarantees, the eligibility criteria that borrowers must satisfy and the type of finance targeted must therefore be determined early on.

Incentives for lenders and/or borrowers to participate depend on the scheme's marketing efforts, the distribution of risk, additional services offered, cost savings in screening and monitoring, the level of fees, the credibility of the guarantor in handling claims and the relations between guarantor and lender. All of these must be specified in contracts between the parties involved.

The level of leverage a scheme achieves and the existence or non-existence of counter-guarantees will have an effect on its sustainability. A scheme's viability is further enhanced through proper regulation and supervision. The chapter concludes by listing additional criteria of successful guarantee schemes. Findings are summarised in table 4.

¹⁴ This chapter is based on the work of Meyer and Nagarajan (1996a), Doran and Levitsky (1997), Levitsky (1997c), the collection of articles published in *The Financier* (1997), Pombo and Herrero (2001), Rute (2002) and a survey conducted by the author (OECD, 2002).

A. Government Institution versus Legally Separate Entity

In many countries, guarantees are extended by departments of the Ministry of SMEs or of Industry. This practice, however, has a number of drawbacks. It may result in a lack of transparency with respect to the finances needed to sustain the scheme. Public officials might be unmotivated and inexperienced in working with small firms and with guarantee schemes, and the bureaucratic procedures inherent in government set-ups will increase the unwillingness of banks to participate. Despite the higher cost involved, it might therefore be advisable to create a legally separate entity with a clear mission statement and organizational strategy.

B. Funding

All schemes seem to require some element of subsidy to survive. This should take the least distorted form possible. The set-up most likely to achieve positive results is a scheme which is in private hands but received some type of start-up help from the government or donors, ideally an initial lump-sum contribution to the guarantee fund.

i. Type of Funds

It is essential that sufficient starting capital and government support are available to ensure an effective launching of the scheme and its subsequent viability. The various forms which funding may take include a levy on participating banks, continued subsidies through soft loans, direct budgetary appropriations, equity or a lump-sum payment. Some schemes are partly financed from the proceeds of a levy imposed on the banking sector. Until 2000, banks participating in the *Korean Credit Guarantee Fund*, for example, were required by law to contribute 0.2% p.a. of the total amount of certain types of loans. Although banks may make considerable use of the guarantee facility to recoup their forced investment, it is equally likely that they reject the scheme from the outset. Indirect subsidisation in the form of soft loans from government or donor agencies is likely to lead to moral hazard since guarantors may expect to be rescued if claims are excessive. Loss-making guarantee schemes can thus continue their operations without being forced to develop efficient operating procedures.

Schemes which are funded through budgetary appropriations (as in the USA and Canada) might be feasible in industrial countries. Lenders in developing countries will, however, rightfully suspect that their claims will remain unpaid if this approach is adopted. In countries facing economic difficulties, government priorities may shift away from guarantee schemes to other areas of policy intervention and funds are likely to shift along¹⁵. In the case of payments, significant delays will result from the introduction of the

¹⁵ This is what happened in Colombia: in 1996, the national guarantee fund received only COL\$1,900 million of the projected COL\$9,900 million due to budgetary cuts necessitated by the government's macroeconomic policy. The fund now aims at privatisation, which it intends to achieve by requiring

government as an additional actor. As in the case of soft loans, budgetary appropriations are likely to lead to inefficiencies and dependency on government action.

Equity is the cheapest form of funding as guarantee schemes are usually not expected to pay dividends. Additionally, it will necessitate regular publishing of reports on the scheme's activity. Transparency of the scheme will thus be enhanced and accountability requirements on the use of public funds will be fulfilled.

The majority of schemes are of the funded variety and have received lump-sum payments to set up the fund. Experience shows that income from fees is insufficient to cover both administrative and default costs of guarantee schemes. The investment of a fixed endowment can provide a source of income to avoid collapse, which does not share the drawbacks of continued subsidies. Whereas fees should be sufficient to cover operating costs, a fund's investment provides income which can be used to meet the cost of claims. To ensure that this is possible, the fund must be sufficiently large and properly invested.

Determining the size of the fund should be preceded by consultation with local banks and potential borrowers to assess the unsatisfied demand for credit which is to be alleviated by the scheme. The fund must be large enough for participating banks to have confidence in that financial obligations can be met. The higher the amount of income from funding, the less conservative must be the guarantor's lending practices and the larger his freedom to experiment with guarantee percentages and fee rates, which are fundamental factors in attracting a sufficient volume of business. However, the fund should not be so large as to induce the scheme to extend guarantees to overly risky borrowers, which would endanger its sustainability. Oehring (1995b) finds that a fund size of \$1.2 - \$1.4 million allows schemes to support themselves.

In addition to determining the size of the fund, the criteria for investment must be properly specified in order to ensure a steady income stream. Management must ensure a sufficient diversification of investment instruments and currencies. Therefore, most public schemes face some kind of regulations stipulating the investment instruments which may be used. An inflation-proof portfolio is of particular importance in developing and emerging economies, as these are often faced with high and volatile inflation, which could erode the fund. When determining the investment instruments, a scheme's management must always keep in mind that sufficient liquidity is needed to meet claims. Investing funds in participating banks will increase confidence in the scheme if banks regard the deposits as a security against their claims. This practice is of course not advisable if the splitting of the fund among various lenders leads to a substantial reduction of the scheme's overall income. Additionally, there is the danger of losing the fund in the event of bank collapse as was painfully learned by RAFAD in Peru.

beneficiaries of the associated regional funds to provide capital worth 2.5% of the guarantee value (Marulanda de García, 1997).

ii. Source of Funds

In many schemes, it is the national government which supplies the funds for the guarantee schemes. In some cases, however, funding is provided by a regional government. In the *Fondo de Garantías Buenos Aires (FOGABA)* of Argentina, for example, the Province of Buenos Aires contributes the complete risk fund and owns 84% of the scheme's shares. Consequently, eligibility to the scheme's services is restricted to firms operating in the province.

In developing or emerging economies, donors may supply most of the funds to establish a guarantee scheme. If this is the case, they are also likely to provide technical assistance in setting up the scheme. The PHARE programme of the European Union has helped to establish several guarantee schemes in transition economies¹⁶. The Dutch aid programme backed the Peruvian *Fondo de Garantía para la Pequeña Empresa (FOGAPI)*, and USAID is particularly active in Africa, Asia and Latin America. UNIDO's assistance in the establishment of two mutual guarantee funds in India is described in chapter 5.

In order to reduce dependency, funding should not be provided exclusively by governments and/or donors. There should always be a contribution from domestic banks, business associations and/or other private sources. This practice, which has proven successful in many schemes operating in industrial economies, has the further advantage of reducing moral hazard on the part of guarantors, lenders and borrowers. However, creating legislation that requires banks to participate in the funding of guarantee schemes is counterproductive. Banks that do not participate voluntarily are likely to provide guaranteed credit only to firms which would have received loans even without the scheme. Additionality will thus not be achieved and the scheme's objective will not be met.

After a public scheme has been in operation for several years, majority ownership should be transferred to participating banks and businesses. In Argentina, *FOGABA* is scheduled for privatisation after ten years of operations. By providing guarantees to small businesses which hold invoices issued by contributing firms, *FOGABA* provides incentives for large corporations to contribute equity capital to the fund.

The financial participation of the private sector and the corresponding influence in the decision-making process of the scheme are especially important in countries where political considerations might tempt the government to extend guarantees to excessively risky borrowers. This was the case in the Colombian *Fondo Nacional de Garantías (FNG)* where the government issued a high percentage of the guarantees to rehabilitated members of guerrilla groups and other risky borrowers. Theoretically, the maximum participation of the public sector in the associated regional funds has now been restricted to 49%. In

¹⁶ Originally the acronym of a European Commission programme targeting Hungary and Poland, the Phare Programme has become the main channel for the EU's financial and technical cooperation with all of the countries of Central and Eastern Europe.

practice, however, it varies between 30% and over 65% (Marulanda de García, 1997; Pombo & Herrero, 2001).

C. Staff and Management

No matter how good the scheme's design and how well funded it is, it will be likely to fail if human resources to implement it are insufficient. Many early schemes collapsed due to unqualified and inexperienced staff. To ensure their efficient functioning, schemes must have a sufficient number of staff that is able to perform tasks such as assessment and approval of applications, monitoring guaranteed loans, processing and reviewing claims, pursuing defaulting borrowers, storing information on borrowers, preparing reports on scheme's operations and possibly offering additional services to both lenders and borrowers. The number of staff needed will depend on whether the scheme operates in a centralised fashion or needs to maintain several branches. In practice, staff size and thus the associated administrative cost vary greatly. Whereas many schemes in emerging economies have about 20 employees, the *Credit Guarantee Corporation of Tokyo* had 685 employees in 10 branch offices in 1992 (Hatakeyama et al., 1997), and the Korean *Credit Guarantee Fund* employed over 2100 persons in 98 branches in 1995 (Levitsky, 1997b).

Social proximity of lenders plays an important role in increasing the motivation to repay. This applies equally to guarantors, who are often misinterpreted as distant public or foreign institutions which are not harmed by defaulting borrowers. A higher degree of social proximity can be achieved by recruiting local staff and having borrowers represented in the scheme's management.

The scheme's Executive Board should include representatives of both borrowers and lenders. Private-sector involvement not only ensures that management has experience with small-scale lending and receives relevant information, but also implies a greater degree of independence of changing government priorities. Such independence may be compromised in schemes in which the government appoints members of the Board. In order to avoid conflicts among the different interest groups represented on the Board (borrowers, lenders, public sector and/or donors), a scheme's mission must be clearly defined in its statute.

D. Centralization versus Decentralization

Early schemes in developing countries were over-centralised. In order to extend the scheme to entrepreneurs in disadvantaged regions, it might be necessary to develop a branch network. Especially in schemes in which the guarantor carries out the risk assessment, it is advisable to establish local presence to improve the process of data collection. Overly centralised schemes may have to rely on limited written information, which cannot be verified independently and will lead to slow decision making (Levitsky, 1993).

Decentralising the guarantee scheme will, however, entail significant extra costs. If participating banks have a branch network, it might be possible to market and operate the scheme through their regional branches instead. If a scheme relies on a bank's branch network to extend guarantees, it may be necessary to train branch staff on how to use the guarantee facility, as lenders may be reluctant to invest time and money in doing so. Since the banking sector is more centralised in developing and emerging economies, the need for decentralisation of schemes is even greater in these environments than in industrialised economies.

Evidence from Europe and Japan has shown that schemes operating in a decentralised manner, i.e. on local or regional basis, are more successful than those operating at national level. One of the main strengths of the Japanese *National Federation of Credit Guarantee Corporations* is seen to be its decentralised structure, which makes the schemes more adaptable to the needs of local small businesses. In Japan, 52 credit guarantee corporations exist, each of them responsible for assessing, processing, and approving applications from enterprises in their region (Hatakeyama et al., 1997). The observation that regional schemes are better positioned to serve the target group than a centralised one led to the introduction of the national guarantee system in Colombia in 1995. The reform established 12 locally supported regional funds, to complement the work of the national guarantee fund (Marulanda de García, 1997).

E. Profit versus Not-For-Profit

An efficient use of resources and subjection to market forces can be ensured by operating on a profit-making basis. However, requiring a scheme to show a profit and to pay taxes as well as dividends may be self-defeating. The *Romanian Loan Guarantee Fund (RLGF)*, for example, tried to safeguard its capital and increase its profits by being overcautious in granting guarantees. The *RLGF* may legally cover up to 70% of the underlying loans, but the actual average guarantee percentage in 1995 was only 34.1%. Transferring all profits to the guarantee fund on the other hand (as in the Argentinean *FOGABA*) will increase the credibility of the scheme and allow an extension of business volume. It may, however, also reduce incentives for private participation¹⁷.

F. Selective versus Portfolio Approach

The decision on how guarantees are to be extended is influenced by the objectives of the scheme. Depending on whether it aims to ensure a *high quality* of guaranteed loans or reach a *maximum number* of borrowers, the guarantee agency may either adopt the selective or the portfolio (also known as global) approach. This also determines the relationship between the guarantee organization and the borrower.

¹⁷ These incentives could be restored through appropriate tax reductions.

The selective approach refers to guarantees extended on a case-by-case basis. Two possible methods can be distinguished. In most schemes, the borrower approaches a potential lender who reviews the project and makes the loan dependent on a guarantee. Either the lender or the borrower will then apply for a guarantee from the scheme. Alternatively, the guarantor issues an advance guarantee approval to the borrower who can use it to negotiate a loan contract with the lender. Since the bargaining power of the borrower is likely to be low despite the guarantee, this may not be in the best interest of the scheme. Either way, a direct relationship between the guarantor and the borrower exists since the former investigates every single loan application and selects which ones to guarantee¹⁸. This reduces the probability of moral hazard on the part of the lender during the screening process (and thus default costs) and ensures that guaranteed borrowers are indeed in the targeted risk category.

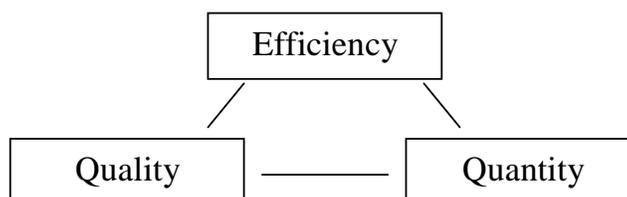
In order to reach a larger number of borrowers and reduce costs, guarantors may opt for the portfolio, or global, approach. Here, accredited lenders are entitled to attach guarantees to loans within an eligible category without prior consultation of the guarantor. Eligibility criteria may be defined in terms of the characteristics of borrowers (in terms of size, sector of operation, gender, location, etc.) or the loan size. In the portfolio approach, there is thus no direct contact between the guarantor and the borrower. As with other forms of insurance, the premiums paid by the lower risk borrowers in the portfolio will compensate for the losses incurred by the higher risk borrowers. This approach enables a considerable expansion of activity by reducing time-consuming and cost-intensive screening procedures. The economies of scale arising from increased business volume will allow more cost-effective operations. Furthermore, lenders become aware that by standardising loan appraisal and monitoring procedures, the costs of servicing small enterprises can be reduced. In Latin America, there has been an increasing trend of guarantee schemes to adopt the portfolio approach. In Peru, its adoption seems to be preferred by participating banks and is said to have led to a reduction of risk perception on their side. By using the portfolio approach, FOGAPI of Peru (established in 1979) was able to extend 44,452 guarantees in 2001 alone. FOGAPI reports a default rate of only 0.21%.

Despite its advantages, the portfolio approach has several drawbacks. True additionality may be lower than under the selective approach if a large proportion of the low risk borrowers awarded guarantees could have qualified for non-guaranteed loans. Above all, default rates may be higher than in the selective approach for two reasons. Firstly, since all borrowers within a specific category are guaranteed there is danger that risk diversification is only limited. Secondly, lenders might be tempted to reduce the screening costs which they incur by being less diligent. However, if banks fear to damage their reputation as prudent institutions with high loan portfolio performance, the danger of moral hazard may not be excessive.

The guarantor must be aware that there is a trade-off between targeting a specific gap in the credit market and making the scheme more flexible and thus attractive to lenders.

¹⁸ Section L below shows that this investigation may be confined to a short control if it was the lender who performed the principal screening function.

Whereas the selective approach will imply high costs and low business volume, the portfolio approach will result in some inappropriate borrowers being guaranteed. Oehring (1995a, 1995b) represents the trade-off by means of the following triangle:



Although its unit costs are high, the selective approach can be seen to be more efficient in achieving true financial additionality since the total cost of mobilising additional credit is lower than for the portfolio approach. The quality of loans guaranteed under the selective approach is also likely to be higher, since screening and monitoring are performed more diligently. However, the overall guarantee and credit volume will be considerably lower than under the portfolio approach, which is able to extend a much higher amount of guarantees for a given fund size. A much greater number of businesses are thus assisted in establishing a good repayment reputation for future loans.

Ideally, both approaches would be combined as shown in the following hypothetical example. If a certain type of enterprise (e.g. those owned by indigenous entrepreneurs) is to be promoted, irrespective of its specific project, the portfolio approach could be used. Other enterprises will have to be selected individually. Alternatively, loans up to a certain amount may qualify for portfolio guarantees, whereas large loans are assessed by the guarantor on a case-by-case basis. Especially in the period following the creation of a scheme, however, it is advisable that the focus be on the selective approach. This allows for the establishment of a good relationship between the guarantor and the lender, which is essential if the scheme is subsequently to be extended by adopting the portfolio approach.

G. Target groups

The target group can be determined with respect to size, sector, age, ownership and/or location of firms. For reasons of simplicity, most schemes use the employment criterion to define eligibility for guarantees with respect to size. Some schemes have also relied on the maximum guaranteed loan size. Exclusive use of this criterion may, however, unintentionally allow larger firms to benefit from the scheme, simply by dividing their loan request.

If micro enterprises are to benefit from the scheme, the design may have to be partially adapted. This could be done through the substitution of intermediaries for formal banks, as in the case of ACCION International, or an increase in the guarantee coverage for micro

enterprises as in the case of USAID's *LPG* (see boxes 1 and 2). Although the effect of micro enterprises on economic growth is lower than that of SMEs, their role in poverty alleviation makes them an important target in developing and emerging economies. *FOGABA* of Argentina for example, has successfully devoted a part of its operations entirely to micro enterprises (see box 3).

Box 3 **Guarantees to Micro Enterprises: The *FOGABA* Experience**

FOGABA's guarantee window to micro enterprises began to operate as of July 1997. Until July 2003, it had extended 256 guarantees with a total value of \$2,217,711. Credits guaranteed by *FOGABA* are used to develop projects in different sectors such as animal breeding and agriculture, industry and commerce as well as services and education.

In 2001, a study conducted by the University of San Martín found that *FOGABA*'s guarantees to micro enterprises were successful in achieving financial additionality, creating employment, increasing sales, and contributing to the development of human capital. 85% of the entrepreneurs surveyed thought that their project could not have been realised without the guaranteed credit received. 57% of this credit was used to start enterprises. These newly-founded firms reported engaging an average of 3.2 employees. In micro enterprises in operation before the guarantee was granted, the average number of employees increased from 3.4 to 3.7. In total, 227 new jobs were created. More than 60% of the enterprises employed persons who were not relatives.

On average, sales income of guaranteed businesses increased by 125%. Whereas 70% of micro entrepreneurs saw their neighbourhood or city as their target market, 26% extended sales to the rest of the country and 4% exported to other countries, mainly to Brazil.

The scheme also contributed significantly to the development of human capital. 56% of micro entrepreneurs followed vocational labour training programmes and 60% participated in courses on administration and management of micro enterprises. This additional training is of particular importance, considering that 90% of the borrowers had not graduated from high school.

In view of the recession and adverse weather conditions it is a considerable achievement that 83% of surveyed micro enterprises were still in operation at the time the survey was conducted, although on average, they were utilising only 38% of their production capacity. Most of the failures occurred during the severe economic downturn of 2000-2001 and mainly involved young enterprises. Of the closed firms, 54% had been in operation for less than a year and 71% for less than two years. The fact that 45% of the closed enterprises are paying the total amount of their instalments from income earned in their current work and an additional 10% is paying part of their instalments gives an indication of the reliability of micro entrepreneurs.

Source: FOGABA, personal communication.

Eligibility criteria may also be determined with respect to the sector in which firms operate and will depend on policy objectives. Thus, labour intensive sectors might be targeted in order to comply with job creation policy goals. The *Rural Credit Guarantee Fund* of Romania, for example, only extends loans to borrowers working in agriculture. The Canadian public guarantee organization, the *Small Business Loans Act* (SBLA), on the

other hand, explicitly excludes the agricultural sector. *Nacional Financiera* of Mexico additionally excludes cattle raising, fishing and mining. Depending on the sectors serviced, it might be advisable to link employment maxima to the sector since firms operating in the service sector are usually smaller than those in the manufacturing sector. Although the benefits of concentrating on a single sector may be a gain of expertise in this area and better targeted additional services, there is the danger that risks cannot be diversified if the target sector is defined too narrowly. Concentrating exclusively on the agricultural sector, for example, may mean that a large number of claims will be made in times of bad harvest, endangering the sustainability of the scheme.

In state-run guarantee schemes, the focus of public policy will usually determine whether start-ups or longer established firms are targeted. The default rates of the scheme will be greatly affected by the segment chosen. Some schemes in developing countries are targeted specifically on transformation lending, i.e. the transition of a borrower from informal or semi-formal finance to formal bank finance. They therefore only authorise guarantees for first-time borrowers. This very restrictive policy is not advisable, however, since its narrow focus will prevent a sufficient diversification of risk and may hinder the scheme from increasing its business volume.

Many guarantee schemes focus on specific groups or enterprises in certain regions. *ASKRINDO* of Indonesia and *CGC* of Malaysia, for example, were set up by the respective governments to reduce social and political tensions between the various ethnicities in the countries (Hatakeyama et al., 1997). In South Africa, the government tries to increase the participation of women and the black population through its credit and guarantee corporation *Khula Enterprise Finance Ltd.* Most schemes restrict eligibility to firms which are wholly or majority owned by nationals of the country in question. The Croatian Guarantee Agency *HGA* has a special programme to promote entrepreneurial activity in war-damaged areas. Some schemes (as the *SICGF* in Thailand) pursue the decentralisation of industry and promotion of rural areas as their main objective. This may be especially important in developing countries which are faced with the threat of continuing rural-urban migration. In some cases, other objectives, such as environmental improvements, might help determine the target group.

The *Transmission Guarantee Fund* of the French SME development bank *BDPME* targets enterprises in the process of transferring ownership. Banks are reluctant to lend for this purpose due to the high rate of unsuccessful transmissions: one bankruptcy in ten is due to poorly managed transmission of ownership. The guarantee fund was established in view of the facts that the 50,000 annual transmissions could possibly affect 400,000 jobs and the observation that more and more small-firm owners were postponing the sale of their enterprises. The resulting ageing of the firm owners had adverse effects on the economy. By operating through a network of 41 branches nation-wide, the *BDPME* is now involved in about half of the cases involving the transmission of ownership in small firms with more than 9 employees (OECD, 2000).

No matter which groups a scheme targets and how socially laudable its assistance to these groups may be, a scheme can only be sustainable if entrepreneurs with viable projects are guaranteed.

H. Type of Finance Targeted

In addition to determining which enterprises are to benefit from the guarantees, a scheme must decide on the type of financial instrument it wishes to target. Thus, it must decide on whether working capital or funds for investment are to be guaranteed. Whereas the former may be important for sustaining jobs in enterprises which could become insolvent due to insufficient short-term credit, the latter are essential for job creation and subsequent economic growth. Since loans for investment have longer repayment periods, they are likely to require a larger amount of collateral and are thus less accessible than working capital to borrowers without guarantees. If the guarantee scheme must concentrate on one of the two options due to a lack of funds, targeting investment capital is likely to create more additionality. Most schemes, however, provide guarantees for both purposes and some schemes also provide guarantees for leasing or for letters of credit. This is advisable since many borrowers are deprived of finance altogether.

Since the objective of a guarantee scheme is to promote economic activity of small enterprises, it is sensible to restrict the purpose to which credit is put. This is likely to have an effect on the default rate since the use for non-productive purposes may make later repayment difficult. As a general rule, guarantees should not be extended for credit used to repay existing loans. In transition economies, however, schemes supporting privatisation have chosen to guarantee these types of loans. To ensure that loans are used for the specified purpose the Croatian guarantee agency *HGA* stipulates that a maximum of 10% of a loan for working capital be paid to the borrower in cash. The rest is directed immediately to suppliers. This effective but rather paternalistic approach might, however, meet with the resentment of many borrowers and lenders and is not likely to instil a feeling of trust among the parties.

Restrictions should also be put on the size of the loan and the length of the term. Whereas a minority of schemes defines minima, most schemes define maximum loan sizes. Reviewing the experience of the Canadian *SBLA*, Riding and Haines (2001) find that extending the ceiling on loan size from \$100,000 to \$250,000 increased the cost of the programme by almost 42% for three reasons. First, the default rate on large loans was higher than on smaller loans. During the period of April 1993 to December 1995, incremental payments to honour defaults by firms that had borrowed between \$150,000 and \$250,000 had amounted to \$77 million. Second, greater amounts of capital are involved in large loans and third, larger loans tend to go into default earlier.

In addition to a restriction on the size of the loan, a ceiling should always be set on the total exposure to any single borrower (and lender). Besides diversifying risk, this is likely to put smaller borrowers at an advantage. In contrast to large borrowers, smaller ones will

most likely be able to receive a guarantee covering the majority of their loan without violating the upper limit and will thus be more attractive to lenders.

I. Marketing

In order to achieve its objectives of improving small firms' access to finance and to assist economic decentralisation, the scheme must be pro-active in gaining recognition and acceptance by lenders and borrowers. Schemes which failed in the past had not acquired a sufficient business volume to be sustainable, partly due to a lack of information of the scheme's potential users on its existence and mode of operation.

Lenders should be made aware of the commercial benefits a profitable micro, small and medium enterprise segment will entail, the simplicity and low cost of the guarantee procedure, the credibility of the guarantee, the transparency of payment triggers as well as the high standards expected of participating lenders. The scheme should not be marketed as a form of social banking but as a measure to service a new, profitable business segment. The message should be conveyed that the scheme can be used as a pro-active strategy to compete effectively for small-scale lending, which will have a positive impact on bank's performance. Being aware of the scheme's benefits in terms of achieving a competitive advantage will reduce the potential for moral hazard on the part of participating banks.

By inducing several banks to participate, the scheme will reach a larger number of borrowers. Also, a scheme involving more than one bank allows comparisons between successful and less successful lenders and lending practices, giving valuable insight into how the scheme might have to be adapted to become more efficient. If a particular bank exhibits a high rate of defaulting borrowers and thus claims, guarantor and lender can examine the reasons and adjust the guarantee coverage or fees if necessary. If the situation does not improve, the guarantor might have to end the business relationship with the particular lender. This was the case in *SEBRAE* of Brazil. The fact that two banks had mainly been responsible for a rise in claims from 9.8% to 13.4% of outstanding guarantees led to the halt of the cooperation between *SEBRAE* and these banks.

Borrowers are often completely unaware of the existence of guarantee schemes and the potential benefits involved. In Croatia, *HGA* tries to reach rural entrepreneurs by organizing meetings with local entrepreneurs in the 21 counties. Additionally, it makes use of the internet, chambers of commerce and is in continuous contact with banks to promote its guarantees. The Romanian *Rural Credit Guarantee Fund* advertises in newspapers and television broadcasts. As most of the participating lenders are also shareholders, they have an interest in promoting the scheme.

Marketing to lenders and borrowers thus plays an important role in implementing a guarantee scheme. In all marketing efforts, however, care should be taken not to increase moral hazard by suggesting that credit will not have to be repaid because defaults will be refunded by a public institution.

J. Risk Distribution

The argument that guarantee schemes may lead to moral hazard among lenders and borrowers is valid (see chapter 2, section D iii). However, through proper design and implementation of the scheme, this danger can be significantly reduced. It is essential that the scheme distributes the risk involved in small-enterprise lending among the three actors in such a way that incentives to keep default and claim rates as low as possible are not eliminated. Thus, the main feature of credit guarantees is that the risk of loss is shared between the lender, the guarantor and preferably the borrower.

i. Lender Risk

Schemes can distribute risk to the lender by means of the guarantee coverage. This should thus always be expressed as a percentage. Guarantees in the form of a fixed monetary amount, only shift risk to the lender for the amount of the loan exceeding the guarantee. If the loan is partially repaid and the outstanding part is below the guarantee level, the scheme will assume the complete risk for this outstanding part.

The guarantee coverage should be high enough to induce banks to participate in the scheme. However, it should not eliminate risk entirely. Risk taking is an inherent characteristic of commercial bank operations as well as a prerequisite for diligent loans assessment and thus for the scheme's viability.

High coverage rates of 100% or slightly below lead to moral hazard and thus high default rates. The *Rural Credit Guarantee Fund* established by the Lithuanian government, for example, offered 100% coverage for loans aimed to finance the purchase of tractors and other agricultural equipment, and required the goods to be pledged directly to the fund. Within three years, it "had become the major machine and tractor station in Lithuania [...]. Masses of loans had gone bad and the aftermarket prices of second-hand agricultural machinery plummeted" (Rute, 2002, p.3). Similarly, when the Canadian *SBLA* raised its guarantee from 85% to 90% in 1993, the result was an immediate and drastic rise in default rates as lenders were induced to advance riskier loans. As a reaction to the rise in the default rate, the *SBLA* reintroduced a guarantee level of 85% in 1995 (Riding & Haines, 2001). Nevertheless, a high guarantee coverage will increase banks' willingness to participate in the scheme. To achieve this aim, without incurring undue losses, the Dutch state guarantee scheme *BBMKB* initially covers 90% of the credit issued and subsequently reduces the percentage annually. Risk is further transferred to the credit institution by requiring that a second, non-guaranteed loan of equal value be extended. If the non-guaranteed loan is awarded to a start-up enterprise, it need, however, only be half as large as the guaranteed loan.

If schemes choose to provide a 100% guarantee, the risk assessment, final lending approval and post-claim loss recovery functions should be performed by the guarantor. In these cases, an extensive and decentralised branch network is necessary and the learning

effect for banks is likely to be reduced. A guarantee coverage of 100% is mainly confined to industrial countries where the financial sector is developed.

A low guarantee level removes the potential for moral hazard and thus encourages diligent loan appraisal on the part of lenders. A guarantee coverage of less than 50%, however, will be insufficient to induce banks to participate since their overall costs of administering the loan will remain high. Even a guarantee of 50%, as offered by some schemes, will be relatively unattractive for banks. Both the guarantor and the lender will aim to reduce the remaining high risk they face by engaging in screening and monitoring. Functions are likely to be duplicated and the overall costs incurred will rise. Additionally, lenders might continue to demand a high amount of collateral from borrowers, rendering the scheme ineffective.

The level of the guarantee coverage should reflect the risk of the underlying loan. The World Bank has therefore proposed to encourage banks to lend to higher risk borrowers by increasing the guarantee for these loans (Levitsky, 1997b). This, however, might lead to excessively risky lending, undermining the true purpose of the scheme and endangering its sustainability. In some schemes, notably in Mexico and Romania, coverage of longer-term investment loans is higher than for loans intended for working capital or leasing.

The Colombian *FNG* tries to provide an incentive to lenders to share more risk by charging higher fees for higher coverage (see table 2). Since lenders are likely to pass the fees onto borrowers, there is a high probability that lenders will not choose the coverage according to the risk of the loan, but will always opt for the highest coverage. Since borrowers are thus faced with higher interest rates, the risk of adverse selection rises. In addition to not contributing substantially to the income of the scheme, the increase in fee rates may therefore even increase overall expenditures.

Table 2 Coverage and Fee Schedule of the Colombian *Fondo Nacional de Garantías*

Percentage of Cover	Fee on Loan Amount
Up to 40%	1.20%
41% - 50%	1.75%
51% - 60%	2.22%
61% - 70%	2.80%

Source: Marulanda de García, 1997.

Experience has shown that guarantee coverage of 60-80% of the loan is advisable. It provides incentives to the lender to properly assess the risk of loans and does not deter them from participating in the scheme. Coverage for portfolio guarantees should always be lower than for individual guarantees since the scheme is not directly involved in screening the borrowers. Also, the guarantee amount may vary for specific categories of firms which governments want to promote. Thus, women or indigenous entrepreneurs might receive a higher guarantee than others. In setting the precise guarantee amount, it is clearly essential

to take the size of the guarantee fund and the expected number of claims into account in order to ensure the scheme's sustainability.

Any repayments made by the borrower should be shared between the lender and the guarantor according to the specified percentage. If a bank receives the entire first repayments made by a borrower who subsequently defaults, the bank can call in the guarantee for the missing amount and reduce its true risk to zero. It will therefore not be motivated to reduce the losses by pursuing the defaulting borrower.

In addition to determining *how much* is guaranteed, it is important to specify *what* is being guaranteed. If the guarantee is issued as a first liability, the bank can call in the guarantee as soon as the borrower is in default and receives the guaranteed portion of the *loan principal*. In the case of a second liability, the bank must sell all the borrower's pledged assets before it can call in the guarantee which only applies to the *actual losses* incurred by the lender. This ensures that the lender has an incentive to pursue the borrower for further collateral collections. However, in countries with deficiencies in the legal system, which make loan recovery difficult, this procedure is likely to lead to long delays in claims payment and may thus discourage banks to participate in the scheme.

Another important issue regarding the guarantee is whether it applies only to the loan principal or also to unpaid interest. Whereas the restriction to loan principal makes the guarantee unattractive to lenders, extending it to unpaid interest may lead to moral hazard on their part. Lenders might be inclined to postpone a claim in order to receive a higher compensation for interest lost. Should interest be guaranteed, it is therefore indispensable that a time limit be introduced in the contract, e.g. up to 90 days after a missed payment. It must, however be ensured that the period specified is not too short and thus does not provoke banks to make precipitate claims.

ii. Borrower Risk

Credit guarantees are incomplete alternatives to collateral because they lack a decisive characteristic: in contrast to collateral, they do not provide a threat to the borrower in case of default. To avoid moral hazard of borrowers, it is thus essential that they adopt part of the risk by supplying as much collateral as possible¹⁹. A personal guarantee from a third party such as a family member or friends should also be acceptable. Although the value will most likely be far below the bank's collateral requirements, it signals the borrower's willingness to repay and transfers a share of the risk to him. Additionally, the requirement to pledge assets implies a mobilisation of savings before the borrower can apply for the guarantee. The guarantor must, however, ensure that collateral requirements are not excessive since the entire purpose of the scheme would be defeated otherwise. In the case of micro entrepreneurs, in particular, accepting personal property whose loss would entail a sharp decline in the standard of living, such as refrigerators or televisions, will be more effective than property which has a higher value but whose loss would hurt less. Since credit guarantees only insure lenders, borrowers will lose their collateral in the event of

¹⁹ A few exceptional schemes such as those in Pakistan and Indonesia attempt to reduce moral hazard by not telling the borrower that his loan is guaranteed.

default and will thus not experience the scheme as a form of government “hand-out”. In order to reduce moral hazard further, borrowers should also be made aware that their failure to repay the loan will result in the denial of future loans. Finally, the scheme should make clear that defaulting borrowers will be vigorously pursued even after the bank has received its payments from the guarantee.

In the case of the Croatian guarantee agency *HGA*, borrowers must pledge any assets acquired with the guaranteed loan as collateral. Failure to do so implies a refusal to pay possible claims on the guarantee. *FOGABA* of Argentina requires small firms receiving a loan in excess of \$100,000 to purchase shares of the fund for a value of \$1200. If shares can only be sold after all liabilities are extinguished, this requirement represents an additional measure against moral hazard. *FUNDES* ensures that borrowers have an incentive to provide effort by requiring that owners work for the guaranteed firm and derive their main source of income from it.

To diversify the remaining risk and thus ensure the scheme’s sustainability, guarantors should always determine a maximum amount guaranteed for any single borrower and lending institution (see section H above). In practice, this is mostly expressed as a percentage of the fund. In the case of *FOGABA*, for example, guarantees granted to a single beneficiary may not exceed 1% of the sum of capital stock and guarantee fund.

K. Additional Services

Besides providing guarantees for loans, many schemes offer additional services to borrowers and lenders. These may include consulting, project appraisals, business plan preparations, accounting, management and marketing training. Additionally, the scheme might establish ratings of the creditworthiness of individual borrowers, which will reduce asymmetric information and facilitate their loan applications in the future. The *Korean Credit Guarantee Fund*, for example, has several credit research centres, which aim to improve the quality of credit information and to provide ratings of local businesses.

Financial services alone do not produce continuous enterprise development. In developing and emerging economies, in particular, borrowers are likely to benefit greatly from services improving their accounting, management and marketing skills since not only financial but also human capital is essential for firms to survive. To convey that the services offered have a value and to contribute to their costs, a fee should be charged for their use. In many cases, however, the services provided are offered at below market rates to ensure the participation of borrowers.

Some schemes, such as USAID’s *LPG*, include mandatory training to bankers to improve their capabilities in small-scale lending. Training and technical assistance to lenders may be more important to the lender than the guarantee itself. Schemes including a training element for bank staff seem to register a greater learning effect than those without. Such training may include portraying the benefits of smaller repayment intervals and cash-flow

projections (rather than the reliance on collateral) or introducing software packages suited for small-scale lending.

The danger of offering additional services to borrowers and lenders, however, is that the scheme performs too many functions at once so that the quality of both the guarantees and the services is likely to suffer. In these cases, the benefits and costs of outsourcing the services have to be considered.

L. Screening and Monitoring

Since guarantee schemes aim to demonstrate the creditworthiness of small-scale borrowers to lenders, it is important that screening and monitoring are properly performed. Whether it is the lender or the guarantor who performs these functions depends on the operational mechanism used and a weighing of the costs and benefits of either option. If a scheme adopts the portfolio approach, the screening and approval functions are entirely performed by the accredited lender. If the selective approach is adopted, the guarantor's approval is required. In either case, approval will be facilitated by clear criteria for eligibility and standardised loan appraisal procedures.

Since the high transaction costs involved in small-scale lending are among the main deterrents for banks to service small enterprises, credit guarantee schemes should aim to reduce these costs. Whereas costs of defaults are reduced through the guarantee coverage, administrative costs may be reduced if the screening and monitoring functions are performed by the guarantor (usually for a fee to deter unjustified applications and to partly offset the costs involved). This division of functions, however, has the disadvantage that banks' ability to gain experience with small-scale borrowers and to develop efficient lending techniques is reduced, i.e. no learning effect takes place. Additionally, banks may doubt the reliability and expertise of the guarantee scheme and duplicate some of the functions, raising the overall costs of the scheme and causing delays. The additional costs, however, may be offset by a reduction in loan losses due to more diligent screening.

On the other hand, if the tasks of screening and monitoring borrowers are transferred exclusively to the lender, his administrative costs will not be reduced, making the scheme less attractive. Additionally, there is risk of moral hazard, which can, however, be diminished through proper design. Schemes may specify a minimum period from loan disbursement before a claim can be made, thus keeping banks from approving poor short-term loans. They may, like the Colombian *FNG*, suspend global guarantee agreements with lenders if a certain percentage of the portfolio covered (e.g. 8%) is overdue for a specified period of time (in the Colombian case, 90 days). Alternatively, the guarantor may reserve the right to lower the guarantee percentage for new loans if an excessive amount of loans are in arrears. To ensure that borrowers have not simply been attracted from other banks and that lenders did not simply transfer the borrower from their regular portfolio (interlender and intraportfolio substitution), schemes might insist that the borrower presents proof that, as a result of a lack of collateral, he has been rejected for a non-guaranteed loan before he qualifies for a guarantee. This will, however, not add to

additionality in terms of better loan conditions. Additionally, this is only feasible in schemes in which the borrower applies directly to the guarantor, due to the possibility of moral hazard on the part of lenders. The same limitations hold for the policy of a Dutch scheme which refused payment of claims if an investigation revealed that acceptable collateral for a normal bank loan was available at the time the guarantee was granted (Levitsky & Prasad, 1987).

No matter which approach is adopted, there should be a clear division of responsibility between guarantor and lender in approving applications and monitoring borrowers to ensure that functions are not duplicated unnecessarily and that costs and delays are kept low. It is also important to keep the procedure simple and to avoid red tape so as to deter neither lender nor borrower. The latter should not be required to fill in additional documents for the guarantee, and the processing of applications should take no longer than 14 to 21 days. This approach has successfully been adopted by *KredEx* of Estonia, which is able to accomplish the entire procedure from the receipt of the guarantee application to the issuing of the guarantee contract within two weeks. As seen in chapter 2, critics fear an increase in the processing time of applications, resulting from the introduction of the guarantor in the lending process. Experience has shown, however, that in some cases, processing times may even be considerably reduced by the scheme. FUNDES, for example, was able to reduce the average time of processing over 1000 loans to 24 days, from the 79 days it had taken the participating banks (Oehring, 1995a).

The division of screening and approval functions will influence the amount of the guarantee and the fee charged. In general, the party assuming the responsibility for selecting borrowers should assume most of the risk. Thus, the guarantee percentage should be lower for the portfolio model than for the selective approach. The screening process should only involve both parties in all stages if risk is equally shared. This, as well as the consequent transaction costs of duplication, should be avoided by increasing the risk share absorbed by either the lender or the guarantor.

The guarantor must always obtain timely information on the borrowers' repayment status. Transaction costs can be reduced significantly by stipulating that lenders will only inform the scheme if a borrower is in arrears. Late reporting should result in the termination of the guarantee agreement, as moral hazard cannot be excluded, i.e. the bank may defer making a claim in order to increase the value of the guarantee by accumulating unpaid interest.

In conclusion, it may be advisable to retain the main screening, appraisal and monitoring functions with the lender, even if the selective approach is used, in order to encourage the learning process. A quick control of the loans for which a guarantee is solicited should be sufficient from the guarantor's side. However, the guarantor should reserve the right to refuse the issuing of guarantees for loans perceived as excessively risky. Guarantee schemes are not aimed at providing finance for projects of doubtful viability. Rejection rates seem to vary considerably among schemes. Whereas *SEBRAE* of Brazil rejects no applications at all, the *RCGF* and the *RLGF* of Romania reject 5% to 6%. In Croatia (*HGA*), Argentina (*FOGABA*) and Estonia (*KredEx*) 12%, 15% and 23% of guarantee

applications have so far been rejected respectively. Although it is certainly advisable to reject some unwarranted or excessively risky applications, overly conservative approval criteria will undermine the scheme's ability to create additionality and make it less attractive to lenders and borrowers.

M. Fees

Guarantee schemes derive their income from the investment of a risk fund (if existent) as well as from fees. Fees signal that the guarantee and services provided have a value and that the scheme is operating under market conditions. Fees can be charged up front or in the form of annual premiums, dependent either on the amount of the guarantee or the underlying loan. For short-term loans, in particular, it is advisable to collect the fees in advance in order to keep additional transaction costs low. If an annual fee is charged, an additional, partly non-refundable application or registration fee (commission) should also be levied to recover the initial costs incurred and to discourage unjustified applications. A commission is particularly important in the case of loans for working capital where the annual income is limited. In addition, it ensures that all borrowers (even those defaulting early) contribute to the scheme. The commission should not be too high, however, to assure that short-term borrowers do not make disproportionate payments to the scheme.

Fees can be levied on the size of the loan or on the amount guaranteed. Those in favour of using the loan amount as a basis argue that fees should reflect the screening costs (when applicable) and the costs of claims, which depend on the risk of the guarantee. These costs, in turn, depend on the size of the underlying loan and not exclusively on the amount guaranteed. Also, it has been maintained that a levy on the entire loan is justified since this is made possible through the guarantee in the first place. On the other hand it has been argued that, in order to avoid resentment by lenders and borrowers alike, the scheme should only charge for the services it actually provides, i.e. the guarantees (Levitsky, 1997b).

When determining the size of the fees, a balance must be struck between the sustainability of the scheme and the willingness of borrowers and lenders to participate. As seen in section B i above, attempting to cover the full costs of the scheme is unrealistic. However, fees should always be high enough to cover administrative costs. As noted by the critics of guarantee schemes, the fact that lenders usually pass fees on to borrowers can lead to adverse selection as interest rates rise and thus may increase the number of claims²⁰. Lower fees combined with income from investment might therefore be better suited to ensure the sustainability of the scheme. In inflationary environments, freedom to adjust fees may be vital to sustainability.

²⁰ On the other hand, the guarantee should reduce the risk premium attributed to the borrower, thus reducing the overall interest rate. Lenders, however, may be reluctant to pass the reduction of risk on to the borrower in the form of lower interest rates in order not to decrease their spreads. This will most likely be the case in countries with low competition in the credit market.

Typically, fees on the outstanding guarantee schemes are about 2% p.a. Since loans guaranteed under the portfolio approach require less administrative work from the guarantor, fees for these loans should be lower than for those approved individually. Schemes may also use fees to provide an incentive for diligent screening, e.g. in the form of a partial reimbursement of fees once a loan has been repaid without a claim arising. Some Latin American schemes have developed innovative ways to adapt the fees to the risk involved in a loan. *SEBRAE* of Brazil adapts the fees charged to the length of the loan. Two, three, five or eight year loans are charged 2%, 3%, 5% and 6% respectively. As was shown in table 2, fees in Colombia rise with the guarantee coverage.

N. Defaults and Claims

The default rate is a prime determinant of a scheme's viability. Defaults and claims are not only a financial liability for the scheme; they also threaten its credibility if not handled professionally. A guarantee scheme thus needs to aim to keep the default rate low, teach lenders to reduce their credit risk, make adequate provisions to meet the projected claims, develop timely, efficient and transparent procedures for triggering and handling claims and pursue defaulting borrowers to recoup as much of their losses as possible.

The scheme must make clear that invoking a guarantee is a last resort after all other attempts to receive repayment from borrowers, possibly even loan rescheduling, have been exhausted. Schemes should strive to achieve a claims rate between 2% and 3%, and certainly no more than 5%, of outstanding guarantees. Whereas a higher rate suggests that borrowers were not properly screened, that the guarantee coverage was too high or fees too low, a lower figure implies that the scheme is overly cautious in granting guarantees. In either case, the reaction should be to improve the procedure used. The UK *Loan Guarantee Scheme (LGS)*, for example, whose average two-year default rate over the 1980s was 26% (Cressy & Cowling, 1995) should have considered reassessing its practice of not requiring borrowers to put up collateral²¹. Newly established schemes in emerging economies are likely to experience claim rates in excess of 5%. The first years of the scheme should be used to adapt procedures so as to reach an equilibrium level of claims at a lower rate.

In order to change the perception of high risk attributed to small-scale borrowers and to safeguard their own funds, guarantors must teach lenders how to reduce the credit risk of small loans. Lenders can reduce defaults in different ways. They need to evaluate an individual borrower's situation rather than to rely on automated screening methods and should require the borrower to demonstrate relevant experience in the activities for which credit is granted. Also, they need to assign risk ratings to new loans which should be reassessed throughout the life of the loan. Finally, they must aim at finding pro-active solutions to deal with problematic loans in order to avoid rapid liquidation.

²¹ Cressy and Cowling (1995), however, attribute the high failure rates to an increase in the real cost of capital as well as inflation-induced uncertainty under money illusion.

Credit guarantees represent contingent liabilities, i.e. liabilities that depend on the default of the borrower. As is the practice in the banking sector, the scheme should estimate the number of claims and make adequate provisions. In some cases, this will mean raising fees or increasing the fund's capital. For young schemes, however, it will be difficult to make reliable statistical projections. Newly established schemes lack the relevant data, they have not developed into maturity, and the equilibrium risk has not been determined. An accurate assessment of the claims rate will, therefore, only be possible after the scheme has been in operation for several years.

A timely, efficient and transparent procedure for triggering claims is essential to gain the confidence of lenders and to avoid costly disputes. The guarantee scheme should always specify the precise circumstances under which a claim may be made. Early guarantee schemes in developing countries failed to do so. In addition to being inadequately staffed to handle claims, these schemes used vague phrases, such as "the guarantor shall ensure that the lender has diligently taken all required steps to recover the loan". This type of language will lead to disputes between the lender and the guarantor about when conditions are fulfilled, ultimately resulting in delays in claims payment and distrust of lenders in the scheme's reliability. The "trigger conditions" for claims may vary depending on the environment. Many schemes in Latin America, for example, specify that legal action against the defaulting borrower must be initiated by the lender. Requiring the lender to exhaust all legal processes before a claim can be made would, however, be unrealistic in countries with a badly functioning legal system. Another common trigger found in several schemes is a fixed period (usually 90 days) after a missed payment. Some schemes also require banks to classify the debt formally as "in default" rather than "in arrears" or "doubtful" before they can issue the claim. This classification implies a minimum period of non-payment and may affect capital adequacy calculations, thereby deterring banks from making false claims.

A scheme's credibility is largely dependent on how claims are handled²². In countries where enforcement of collateral is difficult, banks are likely to accept guarantees as an alternative that enables them to reduce risk and enforce contracts. Guarantees are more liquid and therefore less costly to appropriate for the lender than borrowers' collateral. These cost savings may, to a large degree, offset the additional transaction costs, which critics assert arise from guarantee schemes. In addition to a clear procedure for triggering claims, guarantee payment should thus be made in a timely manner. It is good practice for schemes to introduce a time limit for the settlement of claims. In order to avoid undue delays and create a climate of trust, only larger claims should be subject to an extensive inspection audit before payment is made. Smaller claims, on the other hand, should be randomly verified ex-post. Rejecting claims is valid in situations where specified conditions were not fulfilled and the lender did not screen the borrower diligently. To safeguard the credibility of the scheme, however, the reasons why claims may be rejected should be clearly stated in the guarantee contract and refusal of a claim should always be accompanied by a detailed explanation (e.g. the fee was not paid or the loan was disbursed

²² An Indian guarantee scheme did not pay out 23% of its claims (they were either rejected or withdrawn by the banks). Figures as this one are unlikely to gain lenders' confidence in the scheme's reliability.

prior to the scheme's approval). In practice, one of the most common reasons is that the loan was not used for the purpose specified in the application.

Fluctuations in the business cycle are likely to lead to fluctuations in the number of claims. If the size of the fund is relatively small, the guarantor may be able to save the fund from depletion by paying claims in instalments as is done by the Croatian guarantee agency *HGA*. Many schemes in countries with well-functioning legal systems pay out a certain amount of the guarantee once legal action was initiated and the rest once a judgement has been obtained. Transaction costs can, however, be reduced if payments are made all at once.

Losses can be reduced by pursuing defaulting borrowers after a claim has been paid. Since there may be economies of scale in concentrating recovery activities in one organization, it is sensible to agree on whether the lender or the borrower is charged with this responsibility. Any amounts recovered should be shared between the lender and the guarantor according to the risk-sharing proportion of the loan specified in the guarantee contract. Recovery rates are highest if guarantors take over the responsibility for debt recovery, once claim payments have been made (subrogation). Experience from East Asian schemes shows that at least 25% of losses can be recouped if post-claim loss recovery is pursued vigorously. The Japanese Credit Guarantee Corporations have even achieved recovery rates of over 53%. This, however, will require devoting a significant amount of resources, in terms of staff and funds, to the recovery process.

O. Guarantor-Lender Relations

Good guarantor-lender relations are a prerequisite for the efficient and cost-effective functioning of guarantee schemes. However, it takes time to build the trust that forms the basis of successful schemes. Guarantors are fearful of moral hazard on the part of lenders and these, in turn, lack confidence that risk will be assessed correctly by the guarantor and that claims will be paid quickly and without dispute. It is therefore essential to have written contracts specifying the rights and obligations of the scheme and lenders.

To build trust, it is of utmost importance that neither the guarantor nor the lender are forced into a guarantee relationship, as was often the case in the past. Lenders should be free to decide whether the scheme's services are attractive enough to participate and should not be pressured into extending credit to unviable businesses. In developing and emerging economies, in which the government obliged national banks to participate in guarantee schemes, the problem of moral hazard was amplified as lenders passed the risky parts of their portfolios onto the scheme. Ideally, participating lenders should also be partial owners of the scheme and be represented in the management (see sections B and C of this chapter).

Guarantors should have the freedom to end a guarantee relationship with a lender whose level of claims is disproportionately high. Up to the early 1990s, 65% of the guarantees

extended by the Colombian *FNG* were granted to the *Corporación Financiera de Desarrollo (CFD)*, a publicly-owned development bank. During the 1980s, the *CFD* transferred most of its high risk loans to the *FNG*. Additionally, due to its representation on the fund's board, it was able to reach agreements and claims payments on more favourable terms than other lenders. The concentration of guarantees granted to the *CFD* fell considerably with its privatisation in 1993, when more financial intermediaries joined the scheme (Marulanda de García, 1997).

The choice of the lender will have a considerable influence on the guarantee scheme's overall performance. It may not be advisable to exclusively rely on large banks as partners in the scheme. Although these are more stable than smaller ones, they are less inclined to develop the small-enterprise segment as a new market. Small banks might be more open to adopting a pro-active approach in making use of the scheme.

P. Leverage

Leverage refers to the ratio of total outstanding guarantee commitments to the size of the guarantee fund. Since not all borrowers receiving guarantees will default, and the guarantees (preferably) offer only partial coverage of the underlying loan, a given amount of capital can be used to achieve a much larger amount of lending to small enterprises. Leverage is thus one of the main arguments in favour of guarantee schemes.

High leverage achieved by granting a large number of guarantees can theoretically both contribute to and threaten a scheme's sustainability. Whereas granting many guarantees implies high income from fees, it may also entail a higher amount of claims. Through diligent screening and monitoring, however, defaults and thus claims can be reduced significantly. Additionally, the extension of business volume allows fixed overhead costs to be spread over more guarantees, so that average costs can be reduced. Economies of scale in guarantee extension can thus arise. Finally, high leverage will allow greater diversification of risk. The overall effect of increased leverage rates is therefore likely to be positive.

The positive relationship between a scheme's sustainability and the leverage ratio only holds up to a certain level. Increasing leverage indiscriminately will entail great vulnerability for a guarantee scheme. A maximum level of leverage should therefore be specified, which depends on the scheme's ability to manage its operations. The level of leverage chosen should be determined by expected fluctuations in income from investment, costs arising from claims as well as its age and operating environment. Increasing the leverage ratio takes time as domestic banks and borrowers become aware of the scheme and gain confidence. Aiming at higher leverage levels too soon may lead to pressuring lenders into extending riskier loans, ultimately leading to an increase in losses. The maximum should thus be raised gradually as the scheme matures, acquires reserves and has a considerable proportion of repaid loans in its portfolio.

Experience has shown that long-established schemes operating in industrialised countries with stable financial sectors may achieve a leverage of up to 26 times of the fund's value (see table 3). In developing and emerging economies with unstable macroeconomic environments, by contrast, it is advisable to adopt a more conservative stance and to restrain the leverage to five or at most ten times the fund's value. Leverage levels below two restrict the scheme's impact and defeat its objective of increasing small firms' access to credit.

Due to insufficient business volume, many new schemes and especially those in developing and emerging countries are far from achieving the optimal leverage level. This may either be the result of excessive caution in extending guarantees or from a lack of lender and borrower demand for guarantees, partly due to ignorance of the scheme's existence.

Table 3 Leverage Levels in Selected Guarantee Schemes

Country	Scheme Name	Date of Foundation	Leverage
Germany	Bürgschaftsbanken	1954	26 (1994)
France	SOFARIS	1971	22 (1995)
Croatia	HGA	1995	20 (2001)
Japan	CIC & NFCGC	1937	15 (1995)
Republic of Korea	KCGF	1976	15 (1995)
Peru	FOGAPI	1979	13.8 (2001)
India	DICCG	1981	11
		(1994/95)	
Taiwan	SMBCGF	1974	10 (1994)
Malaysia	CGC Berhad	1972	8.0 (1995)
Mexico	Nacional Financiera	1997	5.0 (2001)
	RAFAD	1985	3.5 (1994)
Brazil	SEBRAE	1995	1.9 (2001)
Romania	RLGF	1993	1.5 (2000)
	ACCION - Bridge Fund	1984	1.4 (2001)
Colombia	FNG	1982	1.4 (1995)
Argentina	FOGABA	1995	0.5 (2001)

Source: Doran & Levitsky (1997), OECD (2002), Otero (2002).

Leverage figures must be interpreted with caution. The leverage ratio will fluctuate with the amount of outstanding guarantees and the size of the fund, which is affected by new appropriations and claims. If a fund is being decapitalised due to a large number of claims and low income, its size will fall faster than the value of outstanding guarantees, leading to a rise in the leverage ratio. Conversely, re-capitalisation of the fund will lower the leverage ratio. This was the case in Colombia, when the leverage level of the *FNG* fell from 2.04 in 1994 to 1.4 a year later as a result of an increase in the fund's capital.

Q. Counter-Guarantees

Some schemes involve more than one tier of guarantee organization. By choosing to reinsure its guarantees by means of a counter-guarantee, a guarantor recoups parts of the losses, should a borrower default. Thus, the counter-guarantor (in most cases a public institution) agrees to participate in the risk assumed by the main guarantor. However, he is not involved in approving the loan applications. In order to avoid moral hazard of the main guarantor, the counter-guarantees should only cover a limited amount of the default risk. Nevertheless, this approach will have a multiplying effect on the capacity of the schemes to grant guarantees. Additionally, lenders' confidence and thus their willingness to participate in the scheme will be increased since a counter-guarantee insures the scheme against de-capitalization.

Examples of schemes receiving counter-guarantees are abundant in industrialised countries but scarce in developing countries. As noted in box 1, the European Investment Fund provides counter-guarantees for European guarantee schemes and associations. In Germany, the *Bürgschaftsbanken* receive guarantees from regional authorities and the national government. In developing countries, by contrast, schemes usually do not have genuine re-insurance elements. Agencies extending counter-guarantees are scarce in Latin America, with the exception of Colombia and Ecuador. Since its reform in 1995, the *FNG* in Colombia acts as a counter-guarantor for the twelve newly established regional funds, guaranteeing 66% of their operations at a cost of 2.5% of the guaranteed amount. It is expected that due to this second level of guarantees, the regional funds will be able to extend guarantees up to 21 times the value of their underlying funds (Marulanda de García, 1997). In Ecuador, a counter guarantor, the so-called *Fondo de Retrogarantía*, financed through contributions of public and private banks, aims to provide the national guarantee system with adequate re-insurance. It is the only part of the system in which the government intervenes directly.

Implicit counter-guarantees exist in Latin American schemes established under the protection of the central bank, such as the schemes in El Salvador and Chile. It is assumed that the state will assume the role of lender of last resort, should the schemes face the danger of collapse due to excessive claims. The effect on moral hazard remains to be seen.

R. Sustainability

In order to achieve a considerable amount of financial and economic additionality over the longer term, credit guarantees schemes must be designed so as to ensure their viability. Many schemes failed in the past because they could not induce sceptical lenders to participate and thus did not achieve a sufficient credit volume to survive. Lack of sustainability is largely a result of bad management. In addition to insufficient marketing, inadequate risk assessment and slow claims handling, the investment of funds is a crucial determinant of a scheme's sustainability.

Most guarantee schemes are not sustainable without subsidies since their income from fees is insufficient to cover the high costs involved. Insurance companies retain their profitability through the pooling of risk. By catering both to high and low risk groups, risks can be diversified. Guarantee schemes, on the other hand, tend to target a specific group which has many characteristics in common and is usually seen as high-risk: micro, small and medium enterprises. As seen in section B i above, government funds should not take the form of continued subsidies but be restricted to the initial capitalisation of the scheme's fund. In most cases, the subsequent income from investment will be sufficient to cover the costs not offset by income from fees²³. Additionally, this will ensure greater insulation from changing government priorities.

Guarantee schemes should always aim at self-sufficiency and financial independence over time. Meyer and Nagarajan (1997), however, warn of confusing self-sufficiency with stability. Although a scheme might have reached full self-sufficiency it should not automatically be considered as stable. Year-to-year cost fluctuations may present a potential danger, emphasising the need to build up reserves.

S. Regulation and Supervision

Guarantees must be safe and liquid securities, which can be enforced juridically if they are to be accepted by lenders. A certain degree of regulation is therefore essential.

Guarantee schemes are either subject to special legislation or are established under the general rules for financial institutions. Experts are divided on the question of whether guarantee schemes should be granted financial institution status. Examples of guarantee agencies that have acquired this status include the *Romanian Loan Guarantee Fund* (1992) and the *Sociedades de Garantía Recíproca* in Spain (1994). It is believed that banks will take schemes that have financial institution status more seriously and be more likely to participate. The main arguments against the granting of financial institutions status and supervision of guarantee schemes are the high costs involved and the possible danger of signalling false soundness of the scheme to the rest of the financial system. Additionally, it is asserted that guarantee schemes are not true financial intermediaries in that they do not take deposits from individuals²⁴ and their collapse would not endanger the entire financial system. Therefore, it would not seem justified to grant guarantee schemes the same access to liquidity facilities and deposit insurance funds as financial institutions. On the other hand, if guarantee schemes are classified as financial institutions, this has important implications for capital adequacy ratios of banks. Loans guaranteed by a government-owned guarantee organization are not subject to capital adequacy provisions, making banks more likely to co-operate with such schemes.

²³ Riding (1997) believes that the parameters of a loan guarantee programme can be manipulated in such a way that subsidies are not required, even in the absence of a fund. This is contrary to the experience of most schemes.

²⁴ This argument does not hold for mutual guarantee associations, which will be discussed in chapter 5.

Even if guarantee schemes are not classified as financial institutions, they should be subject to the same type of prudential standards and supervision. This is essential since, despite their similarity with insurance companies, guarantee schemes perform the primary functions of credit intermediaries: borrower selection, monitoring and risk management. The main benefit of external supervision is that it reduces the risk of mismanagement in the scheme and the necessity of a government bail-out. If the scheme is subsidised, financial supervision ensures a degree of protection of public resources. Supervision does not ensure that guarantee schemes will not fail. In fact, inefficiently managed schemes should go out of business and their survival should not be prolonged through continued subsidies. What supervision does guarantee, however, are standards of operation, accountability, and thus schemes' credibility.

A supervision programme, based on five basic measures, can enhance schemes' financial stability and credibility (Castellanos, 1997):

- Capital adequacy requirements should be introduced as a precaution against financial risk. The precise ratio of capital reserves should depend on the scheme's experience with defaults, payment of claims and recoveries. In light of the average risk of small borrowers it should, however, surmount that of banks and be in the range of 10% to 20% of outstanding guarantees.
- A risk fund should be created to enhance the credibility of the scheme. To ensure the scheme's sustainability and improve its accounting standards, the supervisor should define acceptable investments, minimum liquidity requirements and procedures for valuing investments at market prices.
- Continuous loan portfolio evaluation and subsequent adequate provisioning should be performed to ensure that sufficient resources are available to meet estimated liabilities. If timely settlement of claims is assured, the supervisor should classify the scheme's guarantees as an acceptable security making provisions at the financial institution redundant. In addition to increasing the attractiveness of the scheme to banks, this procedure would provide strong incentives for the good management of the scheme due to the fear of possible downgrading.
- Mandatory accounting standards should be imposed by the financial authorities. Schemes should, for example, be required to report guarantees as contingent liabilities and not only account for them once default has occurred and a claim has to be honoured. A common reporting framework reduces the scope for manipulating accounts and facilitates supervision and comparison of performance.
- A central debtors reporting system should be established to facilitate the screening of borrowers. The threat of being denied future loans provides incentives to repay loans.

The choice of the supervisor depends on the legal framework, development of the financial system, effectiveness of the banking supervisor, and the importance of the guarantee scheme compared to other financial sector priorities. Castellanos (1997) identifies the comptroller general, external auditors, credit rating agencies, and financial supervision

agencies as potential supervisors. If the scheme is run directly by a government agency, it would be subject to broad surveillance of the comptroller general as all other state institutions. However, the assessment of financial strength and control of financial practices is not performed by the comptroller as these fall into the expertise of the banking supervisor.

External auditors enforce a basic standard of transparency in financial accounting at a cost lower than that of financial supervision agencies. Thus, they play an important role as a first element of control. Credit rating agencies, such as Moody's or Standard & Poor's assess the long-term creditworthiness of securities issued by a firm and may evaluate its short-term strength. They are promising candidates to supervise guarantee schemes²⁵. However, especially in emerging economies, their activity is rather limited and they do not constitute the most comprehensive or cost-effective alternative.

In practice, financial supervision agencies, more specifically the banking supervisor, are the most likely candidates to oversee guarantee schemes, provided that the government attaches high priority to the scheme and that the volume of guarantees is high enough to justify the superintendent's effort. The prime benefits of assigning the monitoring function of guarantee schemes to the banking supervisor are his credibility and his experience in monitoring loan portfolios and ensuring adequate provisions. Also, no other agency has comparable access to financial accounts and information kept by banks.

The credibility of guarantee schemes will rise when banks realise that the schemes operate under the same rules that apply to them. However, the costs of additional staff and resources arising to both the public sector and the guarantor must be kept at reasonable levels and should not outweigh the benefits of increased supervision. In some countries, laws may have to be adapted in order to enable the banking supervisor to control the scheme. Furthermore, it will result in a possible dilution of banking supervision and an additional burden for the banking supervisor who must acquire new skills for monitoring small loan guarantees. According to Castellanos, the ideal situation would therefore be to create a new agency which directly supervises the guarantee schemes. Whether the establishment of a new agency would in fact reduce overall costs seems questionable. Schulz (1997) sees no justification for government oversight of guarantee schemes and advocates corporate governance and independent evaluations of schemes by rating agencies instead.

²⁵ In countries with secondary markets for loans, an external rating will facilitate the sale of guarantee-backed loans, thereby increasing the attractiveness of the scheme to lenders. Banks using the scheme of the US *Small Business Administration*, for example, may sell the loan applications as government-backed securities in the secondary market, thereby releasing capital for further lending. Provided that secondary markets exist, this would be particularly useful in countries with low liquidity in the banking system.

T. Additional Criteria for Success

In addition to the criteria discussed in the preceding sections, successful guarantee schemes should meet the following criteria:

- Direct government intervention in the scheme should be kept to a minimum and should be restricted to policy decisions, funding and/or extending counter-guarantees.
- Coordination among the various schemes in one country is important to ensure that efforts are not duplicated. In Romania, for example, the *Rural Credit Guarantee Fund* explicitly targets firms operating in agriculture, which are excluded from the *Romanian Loan Guarantee Fund*²⁶. Within the sectors, however, diversity of firms must be warranted to avoid concentration of risk.
- Co-operation of guarantee schemes on the international level should ensure good practices in scheme design. This has already been successfully attempted among the guarantee organizations in Europe (through AECM) and Latin America (through ALEGA and REGAR). The *Asian Credit Supplementation Institution Federation* (ACSIC), created in 1988, comprises 14 guarantee agencies from nine South East Asian countries. Furthermore, experience and technical assistance from well-established schemes should be drawn on when setting up a guarantee scheme. The Croatian *HGA*, for example, received assistance from the *Buergeres Förderungsbank* of Austria.

U. Summary of Good Practice Indicators

The good practice indicators for the design and implementation of guarantee schemes are summarised in table 4.

Table 4 Good Practices in Scheme Design and Implementation

INDICATOR	GOOD PRACTICE
Government Institution vs. Legally Separate Entity	<ul style="list-style-type: none"> • Creation of a legally separate agency.
Funding	<ul style="list-style-type: none"> • Establishment of a fund from public as well as private sources to obtain income from investment. • Majority ownership should eventually be transferred to the private sector.
Staff & Management	<ul style="list-style-type: none"> • Experienced local staff and representatives of borrowers and lenders in the scheme's management.
Centralisation vs. Decentralisation	<ul style="list-style-type: none"> • Decentralisation of the scheme, if possible through the branch network of participating banks.

²⁶ How the recently established *National Guarantee Fund* fits into the division is not quite clear.

Profit vs. Not-for-Profit	<ul style="list-style-type: none">• Operation on a profit-making basis without the explicit requirement to pay taxes and dividends.
Selective vs. Portfolio Approach	<ul style="list-style-type: none">•• For new schemes: adoption of the selective approach.• For longer established schemes: adoption of a combination, i.e. the portfolio approach to target a specific group of enterprises, or for loans below a certain size, and the selective approach for all other enterprises eligible for a guarantee.
Target Groups	<ul style="list-style-type: none">•• Determination of the target sector with respect to size, age, ownership and location of firms, while ensuring that beneficiaries have viable projects.• Micro enterprises targeted only if scheme can be adapted to their specific needs.
Type of Finance Targeted	<ul style="list-style-type: none">•• Restriction of the purpose to which guaranteed credit is put. If possible: extension of guarantees for working capital, funds for investment and leasing.• Definition of maximum loan sizes and limits on exposure to any single borrower and lender.
Marketing	<ul style="list-style-type: none">• Marketing efforts to lenders and borrowers to achieve recognition and participation.
Risk Distribution	<ul style="list-style-type: none">• Distribution of risk among all participating parties (guarantor, lender and borrower).• <u>Lender Risk:</u>• Guarantee coverage of 60% - 80%, applying to loan principal and unpaid interest for up to 90 days after a missed payment. Whether the guarantee is issued as a first or second liability depends on a country's legal system and whether the guarantor or borrower is charged with loan loss recovery.• <u>Borrower Risk:</u>• Requirement to put up as much collateral as possible, including personal property or guarantees from family and friends.• Requirement to purchase shares of the guarantee scheme if the guaranteed loans exceed a specified amount. Shares may only be sold once all liabilities are extinguished.
Additional Services	<ul style="list-style-type: none">• Training and consulting for borrowers.• Bank-staff training in small-scale lending.• Possibly, outsourcing of services.
Screening & Monitoring	<ul style="list-style-type: none">•• Clear division of responsibility between guarantor and lender, preferably retaining the main screening and monitoring functions with the lender.
Fees	<ul style="list-style-type: none">•• Application fee in addition to annual fee.• Adaptation of fees to risk.
Defaults & Claims	<ul style="list-style-type: none">•• Claims rate of 2% - 3%.

	<ul style="list-style-type: none">• Clear definition of trigger conditions and timely claims handling.• Vigorous post-claim loss recovery.
Guarantor-Lender Relations	<ul style="list-style-type: none">• Building of trust between guarantor and lender.• Independent decision-making of both guarantor and lender.• Involvement of small banks.•
Leverage	<ul style="list-style-type: none">• Determination of an appropriate level of leverage, depending on the macroeconomic environment of the scheme; preferably at least five.•
Counter-guarantees	<ul style="list-style-type: none">• Partial reinsurance of the scheme with a counter-guarantor.•
Sustainability	<ul style="list-style-type: none">• Establishment of a reputation for credibility vis-à-vis lenders and borrowers.• Aiming at self-sufficiency and stability by building up reserves.•
Regulation & Supervision	<ul style="list-style-type: none">• Subjection of the scheme to prudential standards and supervision, including capital adequacy requirements, a risk fund, loan portfolio evaluations and provisions, mandatory accounting standards and establishment of a debtors reporting system.• Choice of the supervisor depending on the characteristics of the respective country.•
Additional Criteria	<ul style="list-style-type: none">• Government intervention restricted to policy decision, funding and/or counter-guarantees.• Coordination among schemes to avoid duplication of efforts.• International exchange on good practice.

CHAPTER IV:

Evaluation of Guarantee Schemes

In the past, few guarantee schemes have been evaluated consistently. As a consequence, many schemes continued their activity despite large losses and poor performance. The result was widespread scepticism about their effectiveness as a measure to improve small firms' access to finance. Comprehensive evaluations of guarantee schemes are thus necessary, not only to account for public and private resources used, but also to improve the performance of individual schemes. Possible methods of conducting evaluations include cost-benefit analyses, micro-level econometric analyses and surveys of participants. A combination of the various evaluation approaches will achieve, albeit at a high cost, a comprehensive picture of the effectiveness of a scheme.

This chapter discusses the variables to be monitored in assessments of guarantee schemes with regard to guarantor, borrower and lender. For each of these actors, the relevant variables to monitor will differ. Correctly measuring a scheme's effect on the borrower will be particularly difficult.

A. Guarantor

To safeguard efficient use of public and private funds and to ensure a maximum of additionality in the long run, the guarantor must be evaluated for his cost-effectiveness and sustainability. This can be achieved by monitoring the appropriations needed to cover losses or the evolution of the fund. Despite the drawbacks of budgetary appropriations discussed above (i.e. no income from investment, dependence on government policy), this method of funding results in more transparency regarding the annual costs. In the case of a fixed endowment, the opportunity cost of the fund must be included in cost-benefit analyses. Whereas measuring direct subsidies is relatively straightforward, the indirect forms of support, such as the provision of office space or secondment of staff, are more difficult to evaluate.

Many early funds were decapitalised since administrative costs and claims exceeded income from fees and investment. In addition to monitoring administrative costs and default rates, the appropriateness of investment decisions must therefore be reviewed systematically. Accounts should be published regularly and audited externally to ensure their reliability. Additionally, it must be ensured that not only the original value of a guarantee is recorded, but also its progress as repayments of the loan take place. In the

past, detailed evaluations of schemes were often impossible to conduct due to poor records maintained by the guarantors and the participating lenders or because appropriate accounting systems were missing in these schemes.

Since the efficiency of the review process not only affects the guarantor's administrative costs, but also the borrower's waiting time, it is essential to evaluate this process in the cases where the guarantor performs the screening and appraisal of applications himself. To ensure good guarantor-lender relations, the time needed to pay out a claim should be monitored and reduced if necessary.

An indication of the effectiveness of marketing efforts is given by the proportion of all bank loans to small enterprises subject to guarantees in the country of operation. Additionally, this ratio helps identify whether an increase in the business volume is desirable. By monitoring the amount of leverage achieved, the fund can determine whether there is sufficient scope for increasing the number of guarantees extended.

High default rates (in excess of 5%) over a large timespan will lead to the depletion of the fund unless it is constantly supported through subsidies or sufficient investment income. Nevertheless, the level of the default rate is not a good indicator of a scheme's performance by itself. A low rate may imply limited activity and high risk aversion. A high default rate may also be consistent with high financial additionality, as was found in a study of the *LGS* in the UK (Doran & Levitsky, 1997).

B. Borrowers

Evaluations of the scheme's effect on borrowers are far more complex than the monitoring of the scheme's sustainability and efficiency. The difficulties involved in correctly measuring additionality explain why there is little evidence on the effectiveness of guarantee schemes with regard to additional lending. Most schemes simply use the number of borrowers covered by the guarantee and the total value of the guaranteed loans to estimate the impact of their operations. This, however, will overstate the true effect of the scheme due to intraportfolio and interlender substitution (see chapter 2, section D ii). Meyer and Nagarajan (1996a) identify methodological complexity, cost and unclearly defined objectives as the main obstacles in accurately determining additionality.

Several methodological problems complicate the measurement of additional lending. Money can be used for various purposes and one unit from one source is completely substitutable for one unit from another source. Due to this characteristic, it is difficult to measure the impact of a guaranteed loan intended for a special purpose, e.g. for buying input. If the borrower had not been able to purchase the input without the loan, the value of the input constitutes the additionality of the loan. If, however, he had purchased the input even without the loan and if he uses the loan as a substitute for the resources previously earmarked for the purchase of the input, the additionality is whatever the borrower does with these resources. In order to evaluate the true impact of the guaranteed loan, the

counter-factual has to be known, i.e. it needs to be determined what the borrower would have done without the guarantee and compare this to what he actually did with the guarantee. Since this is not possible, information on borrowers prior to the guarantee contract is compared to their situation some time later. Alternatively, control groups of borrowers with similar characteristics but without a guarantee are taken to simulate the counter-factual.

These approaches to estimate the impact of the guaranteed loan are problematic for several reasons. Firstly, they do not account completely for all factors which may affect the borrowers or the banks' lending decision. For example, the overall economic situation, government policies, and the degree of competition might influence borrowers' performance. Training offered to bank staff on small-scale lending or an increase in competition in the banking sector will also have an effect on the amount of credit extended to the target sector, even without guarantees. In some countries, banks face lending quotas to certain sectors. Where these overlap with the scheme's target sector, banks might be inclined to accept guarantees for these clients in order to meet their quotas. In these cases, measurements of additionality are distorted. Secondly, there may be a selectivity bias which makes comparison of borrowers with non-borrowers inherently difficult. Hidden borrower characteristics may imply that the control group is systematically different from the borrowers benefiting from the scheme. Thus, guaranteed borrowers will always outperform non-guaranteed borrowers. Thirdly, if the screening function is performed correctly and those borrowers most likely to repay their loans are selected, there will also be a difference between guaranteed and non-guaranteed borrowers. Thus, it is inherently difficult to correctly estimate the counter-factual for both borrowers and lenders.

Evaluations of a scheme's impact on borrowers are further complicated by the need to identify several dimensions of additionality. To assess *financial additionality*, evaluations should not concentrate exclusively on the additional loans to the target sector. It must also be considered whether borrowers benefit from larger and longer-term loans, reductions in collateral requirements and/or interest rates and more rapid loan processing. Measuring *economic additionality*, the indirect effect of guarantee schemes, is costly since the post-loan activities of guaranteed borrowers must be monitored in terms of increased sales, exports, profits, employment, etc. Improvements in borrower's living standards should also be taken into account. Again, the scheme's contribution must be distinguished from other factors influencing the borrowers' performance and should include displacement effects of non-guaranteed competitors and the impact on suppliers in the calculation, in order to achieve unbiased results.

Tackling the methodological problems described involves high costs. Above all, the collection of relevant data and filtering out of other factors is resource and time intensive. Costs could be reduced for the scheme by requiring lenders to collect data on their activities regularly. If these do not perceive the benefits of doing so, however, they will not be willing to assume the additional costs and will be reluctant to participate in the scheme in the first place.

In addition to the methodological problems and the high costs involved, assessing the impact of a scheme is likely to be difficult due to the not clearly defined objectives of many schemes, which influence the data and analysis needed for evaluations. If a guarantee scheme is intended to reduce market failures which hinder borrowers from obtaining credit, it is not financial and economic additionality, but the reduction of the market failures which must be measured. If, however, the ultimate goal of the scheme is to stimulate growth through lending to small enterprises, it must be determined whether guaranteed borrowers grow faster than non-guaranteed borrowers. In short, the effect to be measured should be defined in terms of the objectives of the programme.

If a guarantee scheme is to be justified, it is essential that additionality be measured, despite the difficulties of doing so. In practice, the ability of guarantee schemes to achieve financial and economic additionality varies significantly. Riding and Haines (2001) report that in 1995 alone, about 66,000 additional jobs were created due to the Canadian *SBLA*. Whereas firms receiving *SBLA* loans created 1.53 jobs on average, this figure was only 0.16 for a control group. The costs of job creation ranged from less than \$1,000 per job for small loans to less than \$3,000 for larger loans. The study, however, does not seem to have measured possible adverse effects on competitors of *SBLA*-guaranteed borrowers.

Besides additionality, features of the scheme which affect the borrower and which must be evaluated for their efficiency include possible assistance with credit applications and additional services as well as the length of time until the loan is disbursed. If credit comes too late for a specific transaction, it is not only the transaction but the entire existence of the firm that may be endangered. It must therefore be ensured that the scheme does not increase the amount of bureaucratic procedures the borrower is faced with.

C. Lenders

As noted above, the aim of guarantee schemes is to integrate small enterprises into the formal financial market and to effect changes in the banking sector. Lenders' behaviour and changes in their attitude towards small-scale borrowers must therefore be monitored and evaluated. If the scheme is effective, the graduation rate of guaranteed borrowers as well as the amount of overall lending to the target sector should rise. An increase in the number of borrowers no longer needing a guarantee to obtain a loan suggests that borrowers have benefited from the credit facilitated through the guarantee by establishing a repayment record and possibly by expanding their firms sufficiently to be able to provide the necessary collateral on their own. Moreover, a rise in the graduation rate indicates that lenders are not abusing the scheme and that the scheme itself is not reducing its risk by extending guarantees to previously tested borrowers. In addition to lenders' attitudes, it should also be assessed whether they use the guarantee to market their other products to the borrowers and achieve technological progress in developing cost-effective measures of small-scale lending, which would increase the profitability of small-scale lending and help the scheme achieve its goal.

The claims rate of individual lenders must be monitored so that remedial action can be taken if they rise above a certain level. The quality of borrower appraisal can be determined by identifying the amount of loans that have defaulted within the first year. Thus, if evaluations find that one-year default rates are high, loan decision-making may have to be modified.

In some countries, lenders only participate in guarantee schemes due to political pressure. If returns are lower than for non-guaranteed borrowers, it is essential to assess the effect of the scheme on bank profits. Additionally, it must be taken into account that in these cases non-guaranteed borrowers may be charged higher rates to cross-subsidise unprofitable lending to guaranteed borrowers.

To facilitate evaluations ex-post, it is advisable to collect more data before a scheme is implemented and to stipulate regular monitoring of borrowers and lenders. However, this approach will entail high reporting costs which must be weighed against the beneficial insights such information may yield.

CHAPTER V:

Mutual Guarantee Associations

This chapter is devoted to mutual guarantee associations (MGAs), which differ considerably from other types of credit guarantee schemes. MGAs are solidarity groups, formed by small firms without access to credit. Through their capacity to reduce asymmetric information, these associations are, under certain conditions, able to achieve considerable financial and economic additionality. While MGAs play an important role in Europe, particularly in Italy, they have a relatively poor track record in developing and emerging economies. The first part of this chapter gives a brief overview of MGAs. The second part is a case study of UNIDO's experience in implementing mutual guarantee associations in the Indian artisan clusters of Jaipur and Ambur.

A. Overview

The oldest forms of credit guarantee organizations were independent, private mutual societies of artisans, who, through regular membership contributions, jointly guaranteed credit advanced to one of their members. Borrowing members usually made a supplemental contribution, which was reimbursed once the loan had been repaid and no claim was made. In some cases, additional guarantee premiums were charged. These types of societies continue to exist in almost unchanged form. Mutual guarantee associations today are still self-help or solidarity groups formed by small businesses without access to credit due to insufficient collateral. They are either managed by a separate legal entity created to represent the members or by an NGO, which acts as the implementing agency. In most cases, they are registered as non-profit entities.

MGAs evaluate their members, recommend them to the lender, provide guarantees and pursue defaulting borrowers for loss recovery. They do not, however, extend credit directly to their members. The decisive characteristic of MGAs is that they are based on social capital in addition to financial capital. Guarantees are backed by the capital of the MGA, which is based on the share capital provided by all members and by a risk fund. Hence, each member accepts a commitment for part of the guarantee. Since guarantees are only extended to members, the borrower himself is also liable. Shares can only be sold if the owner's liabilities have been extinguished. As not all members require a loan at the same time and only a small percentage of borrowers is likely to default, members' contributions can have a significant leverage effect.

The status of membership is attributed if a specified number of shares are purchased. An exception is Belgium, where small firms only pay a membership fee to the association and most of the equity capital for the guarantee fund is provided by the government, regional authorities or associations (Levitsky, 1993). This is not advisable since borrowers should also assume some of the risk in order to avoid moral hazard.

Nevertheless, due to the more active involvement of the borrowers themselves, mutual guarantee associations were found to have a better performance record than public guarantee schemes. However, MGA-guaranteed loans, as those of guarantee schemes, only make up a small percentage of the total amount of small enterprise lending.

B. Benefits of Mutual Guarantee Associations

Through their ability to reduce asymmetric information, MGAs are able to achieve a considerable amount of financial additionality and to reduce the overall transaction costs involved in lending. For the degree of asymmetric information to be reduced, however, several conditions must be fulfilled.

i. Reducing Asymmetric Information

Since it is their financial contribution that is at stake, members have an incentive to ensure that only credible borrowers receive guaranteed loans. Due to their social proximity to borrowers, MGAs have a competitive advantage in screening and monitoring borrowers as well as in post-claim loss recovery over other forms of guarantee organizations and banks. MGAs have extensive knowledge of the operating sector of a member and are thus aware of factors such as competition within the sector, market trends or production techniques. Additionally, they assess the viability of an applicant's project by taking the entrepreneur's background, business performance and reputation into account. MGAs are therefore often able to make better-informed decisions than banks, which tend to avoid diverting resources to appraising small loans.

Through peer monitoring and peer pressure, MGAs can ensure repayment and overcome, or at least greatly reduce, the problems related to asymmetric information. Although the mechanisms of peer monitoring and peer pressure have proven very successful in many micro credit programmes, there may be difficulties in utilising this form of collateral substitute among entrepreneurs with established and larger enterprises. Tschach (2000) identifies three conditions, which must be fulfilled for peer pressure to work successfully:

- Group members must be able to distinguish between the unwillingness and incapacity of borrowers to repay. This requires detailed knowledge of their economic and social situation.
- Borrowers unwilling to repay their loans must be adversely affected by social exclusion by the other group members.
- A stable environment must exist, which makes a change of occupation or location costly.

Several attempts to introduce peer pressure in Latin American cities failed because these conditions were not fulfilled. The unconstrained mobility in urban centres and social distance between entrepreneurs meant that their knowledge of individual group members and influence on each other was limited.

For MGAs to be able to effectively reduce adverse selection and moral hazard, they must ensure that sufficient information on its members is available. This can largely be influenced by the set-up of the association. Two types of MGAs can be distinguished: (1) open MGAs, which allow any small enterprise to apply for membership, irrespective of the region or field of activity in which it operates, and (2) closed MGAs, which restrict access to membership by activity or region.

Open MGAs may have difficulty meeting the criteria relevant for successful peer pressure and monitoring. If members of different branches of activity do not know each other, they will not be able to assess their economic situation and the MGA will lack one of the prime characteristics of a mutual benefit association. Closed MGAs, on the other hand, have a greater potential to overcome the problems related to asymmetric information as entrepreneurs operating in the same field are more likely to know each other, e.g. through affiliation in the same associations, and are better able to assess each other's operations. In contrast to other forms of credit guarantees, the restriction to a specific sector can thus be advantageous in MGAs (see chapter 3, section G). In Italy, for example, where one of the most extensive MGA networks worldwide exists, agricultural, craft, commercial and industrial enterprises form separate associations.

Whether open or closed, MGAs face an important trade-off with respect to group size. Whereas small group size enhances the ability to screen and monitor borrowers, its capacity to bear risks and to spread it among members is reduced. As the size of groups increases and the screening and monitoring functions become the responsibility of the administrative bodies of the association, the role of mutual decision-making decreases. Guarantee quality may thus be reduced as membership size and guarantee volume increase.

ii. Financial and Economic Additionality

It was seen that critics of guarantee schemes fear the increase in transaction costs, which the introduction of an additional actor in the credit granting process entails (see chapter 2, section D iii.). In the case of MGAs, however, overall transaction costs may be reduced. The association's greater knowledge of its members decreases information-gathering costs and since the association negotiates the loan contracts for a group of members, economies of scale in contract negotiation can arise.

In contrast to small entrepreneurs, MGAs represent a more equal negotiating partner to banks. Since associations play the role of quasi-borrower vis-à-vis banks, members are able to make use of their association's reputation to receive loans at good conditions. The bargaining power of MGAs is enhanced by the large amount of loans which they administer. Since MGAs can reduce lenders' administrative costs as well as the risk

premium associated to the loan, they may be able to negotiate a reduction in the interest rate and in the security attached to the loan. In order to achieve this goal, MGAs must demonstrate to lenders that screening and monitoring is diligently performed and that guarantees represent sufficient security backed by the entire association.

Unlike other forms of guarantee schemes, MGAs do not explicitly aim at improving the institutional capacity of lenders to service small-scale borrowers. However, experience shows that a partnership between a bank and an MGA can result in a shift of the evaluation criteria from static elements, such as collateral, to a firm's potential for generating a profit (Rossi, 2000).

MGAs are usually based in specific regions²⁷. They are therefore able to appropriate the benefits of decentralisation, playing a considerable role in local development, as experience from Italy has shown. Not only do the guarantees allow an increase in investment, the contributions to the association's capital also represent important savings on the part of small firms. Furthermore, the close relations between the members of an MGA create an environment in which technological, productive and managerial knowledge is shared and innovation is fostered. MGAs offer small enterprises the opportunity to build networks among each other and with other local economic actors such as banks, public administrations and large firms.

C. Organizational Structure of MGAs

The organizational structure of MGAs is depicted in figure 1.

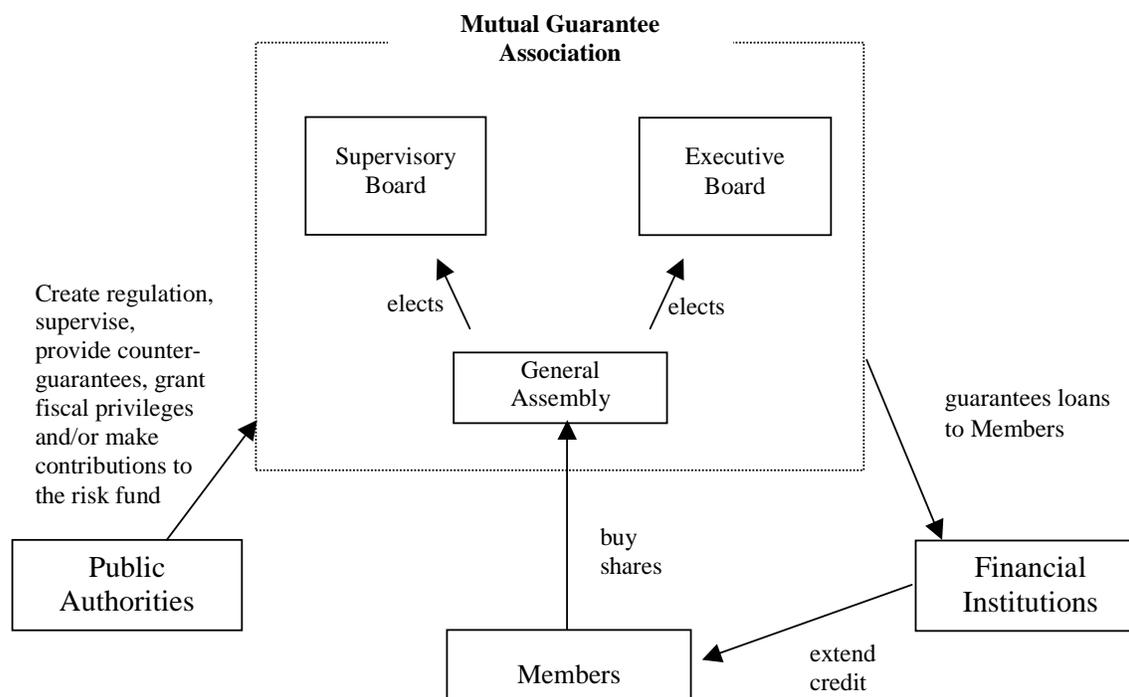
The **members** are small enterprises, which contribute to the capital of the MGA and in turn receive credit guarantees and other services from the association. An MGA's statute will determine the criteria for accepting new members, the number of shares a member may own, the amount of guarantees that may be granted to a single member as well as the reasons and procedures governing the exclusion of a member.

In recent years, MGAs in many countries have moved away from pure mutual structures. In these countries (e.g. Spain) members receive assistance from so-called protecting members. These are national, regional or local public institutions, large enterprises, banks, or industrial associations, which contribute to the association's equity capital and/or make a deposit into the risk fund that backs the guarantees extended.

Although the names and the precise functions may differ among countries and MGAs, the main bodies are the General Assembly, the Executive Board, and the Supervisory Board. Overall authority is vested in the **General Assembly**, which consists of all members, and convenes at least once a year. The Assembly determines investment policies, approves the cost of guarantees, elects the Executive and Supervisory Boards and decides on their

²⁷ Nevertheless, they often form sectorial, regional, national or even international associations such as AECM or REGAR (see chapter 2, section Bi.) to perform representative or lobbying roles and to promote the harmonisation of their legal frameworks.

Figure 1 Organizational Structure of an MGA



remuneration. The **Executive Board**, which administers and represents the MGA, is typically made up of three representatives of members. In some countries, these must make a deposit, whose amount is determined by the General Assembly, as a guarantee for the good discharge of their duty. The Board nominates the association's managers, decides on the admission and exclusion of members, grants or denies guarantees and determines the investments to be made according to the rules set by the General Assembly. In some MGAs, e.g. in Italy, a separate committee is established for the screening of applications. The **Supervisory Board** monitors the guarantee contracts, investments and the state of the association's capital, reserves and risk fund.

Financial institutions extend credit to the beneficiary firms which have received a guarantee from the MGA. To avoid a concentration of risk, most MGAs define the maximum percentage of outstanding guarantees which may be assigned to any financial institution. As in other forms of guarantee schemes, financial institutions benefit from a reduction of risk and administrative costs involved in small-scale lending.

Intervention of **public authorities** should be restricted to regulation, supervision, the provision of counter-guarantees, possible fiscal privileges and/or contributions to the risk fund. Legislation for MGAs varies greatly among countries and ranges from no regulation at all to specifically devised regulations. Since members contribute to MGAs, supervision of the association is important to protect the deposits. Counter-guarantees are often

extended to MGAs by existing state guarantee schemes. As in other forms of credit guarantees, counter-guarantees reduce the level of effective risk for the MGA and allow the association to increase its leverage, while decreasing its incentives for diligent screening and monitoring. Tax exemptions and contributions to the risk fund have similar implications. Excessive government intervention in MGAs reduces the feeling of ownership among borrowers, which is fundamental for the successful operation of these types of associations.

D. MGAs in Europe

In Europe, government support for MGAs is particularly strong. This is demonstrated not only by the Communication SEC(91) 1550 of the European Commission, which recognises the potential of MGAs to improve the financing opportunities for small firms, but also by the EU-backed formation of the European Association of Mutual Guarantee Societies (AECM).

Table 5 presents key data on MGAs in EU-member and candidate countries. Since associations in the latter countries were only established in the 1990s, their lower activity level is hardly surprising. Together, MGAs in Europe reach out to over 2 million small and medium enterprises. In 2000, they provided guarantees for over EUR 14.5 billion.

Table 5 Mutual Guarantee Associations in Europe (December 31st, 2000)

	Own Funds ¹	Outstanding Commitments ¹	Leverage (Commitment / Funds)	Number of SME beneficiaries	Guarantees granted in 2000 ¹
EU-Member Countries	2,252,650	23,217,948	10.30	1,421,776	14,173,907
Candidate Countries	332,383	655,740	1.97	619,908	405,615
Total	2,585,033	23,873,688	9.21	2,041,684	14,579,522

¹ in thousands of EUR.

Source: AECM, personal communication.

MGAs in most European countries (Spain being one of the main exceptions) are set up as cooperatives. Nevertheless, mutual guarantee associations in the various countries are far from homogeneous. Their institutional and operational differences depend on the specific features of the national financial system and the structure of small firms in the respective country. MGAs operating in Italy traditionally service short-term credit needs (95% of total guarantees). Spanish MGAs, by contrast, focus primarily on long-term credit. Whereas Spanish MGAs offer a guarantee coverage of 100%, MGAs in Belgium offer only 50%, and the average coverage in France and Germany is about 80%. Time for

guarantee approval ranges from less than a week in Belgium to four to six weeks in Germany²⁸.

Although its experience with MGAs is fairly recent compared to countries such as France and Belgium, Italy has one of the most extensive MGA networks worldwide²⁹. About 800 MGAs are currently operating in Italy, comprising over one million members from industry, artisanal sectors and commerce. The *confidi*, as MGAs are known in Italy, have been one of the driving forces behind entrepreneurial development throughout the country. The first MGAs in Italy date back to the 1950s. They gradually spread from central to northern Italy and to the rest of the country. Today, the majority of member firms come from the northern regions, although the number of *confidi* is relatively balanced throughout the country. This phenomenon may be a result of the dynamic industrial districts, which are mainly concentrated in northern and central Italy. Throughout the 1970s and 1980s, there was a steady rise in the number of *confidi*, the number of associated members and the value of guaranteed loans. This was only partly offset by a consolidation trend among the *confidi* in the 1990s. Although the number of *confidi* have dropped, the number of member firms and the loans enabled through the collective guarantees have steadily increased. In the 1990s, changing financial market conditions resulted in a diversification of the activities of the more active *confidi*. Some now extend guarantees to leasing and factoring operations and offer financial and credit advisory services.

Although regional and national legislation exists with regard to mutual guarantee associations and the public contributions they may receive, Italian legislation does not prescribe specific modes of operation. In Italy, the *confidi* act as intermediaries between the firms and public institutions. Public contributions to the associations' funds represent an efficient mechanism of channelling resources to small firms. As in other guarantee schemes, government involvement increases the amount of guarantees that can be granted, but may also introduce a moral hazard element in MGAs.

The defining, and interrelated, characteristics of Italian MGAs are their strong local ties and the support they receive from business associations. Their proliferation was greatly promoted by the active assistance of artisan associations and local chambers of commerce. As SMEs faced increasing difficulties in obtaining access to credit at reasonable cost, trade associations encouraged their members to create MGAs that had the potential to negotiate credit at favourable conditions. *Confidi* often have their office space within those of trade associations and sometimes even use their staff. In fact, about 10% of artisan *confidi* do not have staff of their own. The strong involvement of local associations contrasts with other European countries, where the creation of MGAs was often partly the result of government initiatives. Through their links to these associations, members share a common bond which facilitates the MGAs' operations.

²⁸ For a detailed overview of mutual associations in Europe and the rest of the world, see Pombo and Herrero (2001).

²⁹ Information provided on MGAs in Italy draws on UNIDO (1998), Rossi (2000), Pombo and Herrero (2001) and De Gobbi (2002).

In contrast to most MGAs, Italian *confidi* have a large member base, ranging from several hundred to thousands of members. This implies a vast amount of funds to back guarantees. Despite the large size of *confidi*, which automatically entails a dilution of peer pressure, they have been very successful. This can mainly be explained by the strong local context in which the Italian *confidi* are embedded and the important role played by sectorial associations in their development.

Since defaults of *confidi* members are about 10% lower than in the case of non-guaranteed loans, banks actually compete with each other to work with the local MGA. The *confidi* have steadily been able to reduce the guarantee level of each loan and thus expand the number of firms assisted and/or the size of the underlying loan.

To ensure cooperation on a national level, individual MGAs are grouped into five federations, each encompassing *confidi* of a specific sector. These federations have in turn created the *Coordinamento Italiano Confidi*, which represents the entire Italian MGA system.

E. MGAs in Developing and Emerging Economies

The success of MGAs in Europe has induced replication of these types of guarantee associations in developing and emerging economies, where small enterprises face even greater problems in accessing finance. As with other guarantee schemes, there have been unsuccessful attempts to introduce MGAs in developing and emerging economies. In the Philippines, for example, enterprises and banks were unwilling to participate in the *Cottage Enterprise Financing Project (CEFP)*, which was partly financed by the World Bank and the German development bank *KFW* (Levitsky, 1993). This experience reveals that the decision to found an MGA should come from the small enterprises themselves and that banks should not be restricted in the interest rates they may charge, as was the case in the *CEFP*. Further experience with MGAs in developing and emerging economies suggests that a certain degree of technical know-how among at least a part of the associations' members is necessary to ensure that guarantees are not solely extended as a result of non-economic criteria.

Mutual guarantee associations, like other forms of credit guarantees, are not only technical instruments, but also and crucially cultural products of the region and socio-economic system. Successfully replicating this model therefore requires adaptation to local realities, without which the associations could lose most of their potential (Rossi, 2000). When UNIDO introduced MGAs in India (see below), the adaptation of the Italian model to the local Indian context was one of the main concerns.

F. UNIDO-Assisted MGAs in Jaipur and Ambur, India

In the context of its Cluster Development Programme in India, UNIDO launched the "Mutual Credit Guarantee Fund Scheme", or MCGFS, in Jaipur and Ambur to assist local

entrepreneurs in obtaining formal credit. The vast majority of artisans in the two clusters does not have a bank account and does not make use of banking facilities for business transactions. The scheme was thus introduced to build relationships between the banks and the artisans, change banks' attitudes towards them, and make credit facilities available to artisans without collateral. Although state-run credit guarantee schemes have existed in India since the 1960s, the mutual guarantee association in Jaipur was the first of its kind in the country.

i. The Textile Printing Cluster of Jaipur: Background

In the textile printing cluster of Jaipur, colourful hand-block printing goes back 300 years. Today, approximately 550 small firms, engaged both in hand-block and screen printing, provide employment to almost 10,000 workers in Jaipur. Throughout the 1980s and 1990s, exports from Jaipur increased steadily due to the rising worldwide demand for ethnic design and environment-friendly dyes. Traditional hand-block printers based around the city of Jaipur, mainly in the villages of Bagru and Sanganer, failed to keep up with the growing demand for their products and were faced with increasing competition of locally-based screen printers. The latter not only took advantage of the hand-block printers' reputation by copying the same designs, but also faced lower costs due to faster production methods and the replacement of vegetable dyes with synthetic ones. Nevertheless, the textiles were marketed as having been printed with natural dyes. In the context of its programme "Development of Clusters and Networks of SMEs", aimed at making the cluster more dynamic and competitive, UNIDO conducted a diagnostic study and found that inadequate access to credit was among the most significant obstacles to improving the potential of traditional artisans in the cluster.

To improve the competitiveness of traditional hand-block printers and to enhance the economic capacity of the cluster as a whole, UNIDO, in cooperation with the Small Industries Development Bank of India (SIDBI), set up the MCGFS in June 2000³⁰. The scheme was conceptualised by UNIDO and SIDBI based on the mutual guarantee model extensively used throughout Italy. A UNIDO-organized visit to Italy made senior SIDBI staff aware of the crucial role of credit facilitated through mutual guarantees in Italian clusters. It was perceived that such a scheme could be of great importance in the Indian context.

ii. Set-up of the MCGFS in Jaipur

Once the scheme was conceived with and approved by SIDBI, meetings with the printers and potential lenders were organized by SIDBI and UNIDO. Views expressed by the bankers and the printers were incorporated in a draft scheme.

The MCGFS is comprised of individual groups of 10 to 15 members, which are similar in

³⁰ Other activities undertaken in the framework of the Cluster Development Programme include trust and vision building of firms and entrepreneurs, the development of inter-firm cooperation within the cluster, market orientation programmes, design improvements, technical upgrading and capacity building of networks and associations.

size, credit needs and repayment capacity. With the assistance of an implementing agency, these members deposit their lump-sum contributions in a participating bank and thus provide the collateral to guarantee each other's loans. The minimum contribution is Rs 5,000 (equivalent to about US\$ 100) per member. However, members are free to make larger deposits if they wish to do so. After members' payments have been deposited with the lending agency in the form of interest-bearing fixed deposits, SIDBI releases a matching contribution for an equal amount in the form of an interest-free loan.

Members' contributions and those from SIDBI jointly constitute a group's fund. Based on this deposit, which represents a liquid guarantee for the bank, individual loans are disbursed both for working and investment capital. Due to group members' inexperience with credit, the loans granted initially amount to only twice the amount of the group's collateral security³¹. Members do not face additional traditional collateral requirements. The loan is to be repaid in monthly installments, which ensures that members are not overwhelmed by having to repay large sums after a specific time period.

In addition to the monthly installments, members make monthly payments of Rs 100 (US\$ 2) to a reserve fund. Within five years, this reserve fund is to be sufficiently large to repay SIDBI's zero-interest loan. The surplus of the reserve fund and the fixed deposit, after meeting all liabilities towards the lender and SIDBI will be distributed among the contributors to the fund, after the implementing agency has recovered any outstanding service charges.

The scheme foresees the establishment of two separate committees to ensure the viability of each group and to reinforce the banks' trust in the scheme. Whereas the Recommendation Committee screens the loan applications, the Monitoring Committee oversees the repayment of loans. Both committees are composed of one representative of the implementing agency, one representative of SIDBI and three representatives of the group members. In addition, the Monitoring Committee also includes a representative of the lending bank. Through a clear division of responsibilities and by avoiding duplication in record keeping and storing of information, transaction costs and delays are minimised.

iii. Actors Involved

UNIDO not only offered technical expertise to launch the scheme, but also provided financial support to promote its operations. For example, it granted funds to the implementing agency to pay for the staff time necessary to effectively launch the scheme.

SIDBI's involvement provided a crucial impetus to the scheme in its nascent stage and made its replication at the national level more likely. Its financial contribution to the scheme ensures that the fund is sufficiently large to have an impact. Additionally, it reassures the lending agencies involved in the scheme and, due to the increased leverage effect, provides additional motivation to small-scale borrowers to participate. In addition to its matching contribution, SIDBI provided resources to promote the launching of the scheme in Jaipur and its operations in the first two years.

³¹ In Ambur (see below), the banks are financing 2.5 times the amount of the deposited fund.

Besides UNIDO and SIDBI, the actors involved in the scheme are the implementing agency, the lending agency and the group members themselves. At the operational level, a local NGO, the **Indian Institute for Rural Development (IIRD)**, acted as the implementing agency for the project. It initiated the implementation of the scheme by developing an operational framework and by creating awareness among local artisans and banks. A rapid implementation of the scheme was fostered by the fact that several printers had previously participated in other activities organized by IIRD and thus trusted the NGO.

Since members are not organized in a legal entity, as is the case in many other mutual guarantee associations, IIRD takes on this role. IIRD supports the operations of the mutual guarantee association by:

- Assisting entrepreneurs in the formation of viable mutual guarantee groups;
- Organizing initial meetings of members;
- Initiating confidence building measures;
- Contacting the participating banks and acting as a link between banks and borrowers, e.g. by introducing the groups to local bankers, recommending project proposals to the participating banks for approval, collecting members' contributions and creating a separate fund for each group;
- Collecting the monthly installments of group members.
- Monitoring the utilisation of the fund by maintaining records of deposits, loan amounts, guarantees, monthly deposits and service charges, etc. These records must be made available for periodic audits by SIDBI staff.

To cover administrative costs, IIRD charges an annual fee of 3% on the outstanding principal amount. Moreover, it may charge a consultancy fee of 1.25% for additional services provided to a member (e.g. assessment of credit needs or assistance in the preparation of loan applications).

Regular meetings with several **local banks** resulted in the participation of the Bank of Baroda, the State Bank of Bikaner & Jaipur and the State Bank of India. Their participation promoted a dialogue between banks and printers that resulted in changes in bank staff's attitude towards small firms.

Printers choose their own peer groups to ensure that they feel comfortable with guaranteeing each other's credits and can influence each other in all financial issues, especially with respect to payment of monthly instalments. Due to the pre-existing contacts among group members and with IIRD, risk assessment and subsequent follow-up are facilitated. Since all borrowers have a stake in each loan, the social pressure among borrowers ensures that defaults are minimised at no additional cost. An agreement was made between group members and IIRD in order to bind the members to the norms and

conditions of the mutual guarantee association. Members were warned that merely receiving a bank loan should not be their main objective, and that the ultimate goal should be to promote their businesses and to repay the loan for recycling, i.e. enabling other members to obtain credit.

iv. Results

In July 2003, six groups of printers (65 artisans) had received loans worth Rs 1.5 million (US\$ 30,000) from banks. Repayment has generally been prompt. Despite this success, the MCGFS is facing some challenges. Due to the small loan base, the sustainability of the scheme is not yet achieved. Moreover, credit volume is constrained by the reluctance of banks to increase the leverage level. Staff turnover in participating banks, i.e. those who were initially sensitised to the scheme being replaced by staff lacking experience in this field, is also adding to problems in implementing the scheme.

v. The Leather Cluster of Ambur: Background

Ambur is one of the leading leather clusters in India. It comprises many heterogeneous firms, ranging from micro enterprises catering to local markets to vertically-integrated, export-oriented corporate groups engaged in export of finished leather and shoes. The cluster accounts for 12% of Indian leather exports and 20% of shoe exports, with a total value of about Rs 6 billion (US\$ 120 million). However, the lion's share of exports from the cluster are made by the high profile, export-oriented, vertically-integrated corporate groups (6 units controlling 24 other units). The almost 120 micro enterprises in the cluster manufacture low-price shoes and sell solely in local markets. The successful implementation of MCGFS in the Jaipur cluster and the inability of micro enterprises (tiny shoe units) in the Ambur leather cluster to make use of their potential, prompted UNIDO to replicate the scheme in Ambur.

vi. Set-up of the MCGFS in Ambur

The action plan adopted by UNIDO and SIDBI followed the same steps as in Jaipur:

- Identification of a registered society, an association or an NGO, which will function as the Implementing Agency (IA).
- Identification of one or several bank(s), which will act as lender(s) under the scheme.
- Assistance in the formation of borrower groups. In the early stages, active sensitisation campaigns were necessary. It was assumed that once entrepreneurs learned about the benefits of the scheme, they would approach the implementing agency for an extension of the scheme (see below).
- Constitution of a Recommendation Committee (RC), consisting of a representative of the implementing agency, 2-3 members of the group and possibly a representative of SIDBI. The Committee's task is to appraise the loan applications of group members and to recommend members to the lending agency. Detailed appraisal and the final lending decision lie with the lending agency.

- Collection by the implementing agency of the initial deposit of Rs 5000 (US\$ 100), or more, from the beneficiaries and deposit of the amount in the lending agency. Additionally, pledging this fixed deposit with the bank as collateral security for the duration of the scheme.
- Matching contribution from SIDBI on acknowledgment by the lending agency that members' contributions have been deposited.
- Opening of a bank account in favour of SIDBI in which the monthly contributions collected from the beneficiaries are deposited.
- Signing of an agreement by all group members to adhere to the terms and conditions of the scheme.
- Issuance of a letter from the lender conceding second charge of both fixed deposits (i.e. the members' and SIDBI's contribution) to SIDBI.
- Disbursement of loan by the bank to the group members.
- Constitution of a Monitoring Committee (MC), consisting of one representative from SIDBI, one representative of the lending agency and 2-3 members from the group, to ensure the smooth functioning of the scheme. The MC must convene at least once every 3 months to review the repayment progress and to take corrective measures if necessary.

vii. Actors Involved

UNIDO was active in promoting the MCGFS and supporting its operations. A series of sensitisation campaigns was conducted, during which the artisans became aware of the schemes and the benefits it could entail for them.

To put the scheme into operation, it was necessary to identify an implementing association, such as IIRD in Jaipur. The **Tiny and Small Scale Shoe Makers Association (TASSSMA)** was identified for the role. Members of TASSSMA were sensitised to the MCGFS and the first group of borrowers was formed. A series of group meetings was held to reinforce the group concept. Simultaneously, all **banks** in Ambur were contacted. They received information on the scheme and were asked to act as a lending agency under the scheme. Initially, no bank showed interest. However, after discussions with UNIDO, the Syndicate Bank agreed to participate in the scheme as a lender. To clarify the roles and responsibilities of the participants in the scheme, a meeting was held in Ambur, involving the beneficiaries and representatives of the bank and SIDBI.

viii. Results

In August 2001, the contributions made by the first group of 10 beneficiaries, Rs 10,000 each for a total of Rs 100,000 (US\$ 2,000), was deposited in the Syndicate Bank as a fixed deposit for five years. The matching contribution was released by SIDBI in December 2001. The first batch of loans, Rs 50,000 (US\$ 1,000) to each member of the group, was disbursed by the Syndicate Bank in January 2002.

Word spread quickly among the shoemakers in Ambur that TASSSMA was helping micro entrepreneurs to receive formal bank credit, leading to the demand for more groups. TASSSMA took a cautious approach and attempted to identify only entrepreneurs who were genuinely interested in business development. Additional groups were only to be created once the first group had repaid several instalments.

A second group of borrowers was promoted in spring 2002. The members of the second group contributed Rs 5000 (US\$ 100) each. In April 2002, the total amount of Rs 50,000 (US\$ 1000) was deposited in the Syndicate Bank as a fixed deposit for 5 years. Immediately, SIDBI was approached for a matching contribution of Rs 50,000, which was received in May 2002. The bank disbursed the loans of Rs 25,000 (US\$ 500) to each member in June 2002.

In July 2003, three groups of ten beneficiaries each had been established and a fourth one was under formation. A total of Rs.1,000,000 (US\$ 20,000) had been disbursed by the bank as working capital loans to the members for their business development. A study of the performance of assisted units revealed that on an average these units have increased turnover by about 20%. There has not been a single default in repayment of loans. Until July 2003, group one had repaid 16 instalments (out of 36), and groups two and three had repaid twelve and two instalments (out of 30) respectively. An increase in the leverage level (up to 4-5 times the underlying funds) is foreseen when the first group completes the payments and opts for further loans under the MCGFS.

The Ambur MCGFS owes its success to a great part to the due care taken by TASSSMA in selecting beneficiaries, its diligent record keeping and the meticulous follow-up of repayments. Meetings of the Monitoring Committee have been held periodically and SIDBI officials have appreciated the manner in which the scheme has been implemented by TASSSMA and the Syndicate Bank.

Besides Syndicate Bank, two more banks, Canara Bank and Indian Bank, have voiced their interest in being associated with the scheme. One of these banks may become the lending agency for the next group.

ix. Lessons from the Jaipur and Ambur Schemes

The MCGFS in both Jaipur and Ambur have incorporated some elements from micro finance and thus differ in several respects from traditional mutual guarantee associations. Firstly, the introduction of several small credit groups within the scheme is unusual and is mainly the result of members' reluctance to join larger groups. It ensures that participants have the close relationships necessary to be able to exert peer pressure over each other, thereby contributing to the scheme's sustainability. Due to the matching contribution made by SIDBI, relatively large loans can be granted despite the small size of individual groups. Secondly, in most MGAs, loans are not distributed to all group members at the same time. The fact that all group members receive a loan relatively swiftly reinforces their motivation to participate as they see the direct benefits for themselves. Nevertheless, this practice significantly reduces the amount of credit granted to any single borrower and thus limits the scope of investments that can be undertaken. UNIDO has therefore

recommended moving to a more traditional approach wherein individual members receive larger amounts of credit one after another.

The main challenge for the scheme is its sustainability. The small size of individual groups considerably restricts the maximum loan size and thus limits the fees attainable for the implementing agency. However, if successful such a pilot scheme could lead to wider replication in many artisan clusters. In fact, SIDBI and the Indian Ministry of Small-Scale Industry are considering expanding the scheme to other Indian clusters.

The MCGFS has been found to be a very useful and effective tool in providing access to credit for artisans and in developing a healthy and long lasting business relationship between banks and micro enterprises. Through changes in the approach of lenders, the scheme crucially contributes to the development of institutional capacity in the supply of small-business credit in the long run. Additionally, it encourages entry of small firms into the credit market. The MCGFS' positive results indicate that unsuccessful attempts to replicate mutual guarantee associations in developing and emerging economies are mainly due to a lack of customization to local realities, rather than a result of the MGAs' inapplicability to developing countries.

CHAPTER VI:

Conclusion

Credit restrictions tend to hinder small firms from developing their full economic and social potential and can therefore have considerable adverse effects on economic growth in the long run. Lack of formal credit is, to a large degree, the result of imperfections in the market for credit to small firms, thus justifying government intervention. This paper focused on credit guarantee schemes as a possible remedial measure.

By reducing the risk to banks associated with small-scale lending, credit guarantees attempt to interest lenders in this market segment and to initiate a learning process through which banks develop the know-how and technology to make small-scale lending profitable. Obtaining finance for working capital, investment and/or leasing purposes enables small businesses to improve their competitiveness and to extend their economic activity. To the extent that access to capital and/or more favourable loan conditions stimulate productivity-enhancing investments by small firms, credit guarantee schemes do not only improve the performance of these firms, but also act as a stimulus for private sector-led growth. Their potential to promote small businesses and development, however, is not restricted to their role in enabling investments in physical capital alone. By offering consulting and training to entrepreneurs, guarantee schemes also contribute to the accumulation of human capital. Targeting enterprises in rural areas can assist regional development and help decrease rural-urban migration. In developing and emerging economies in particular, schemes may support the formalisation of micro enterprises and improve economic opportunities of marginalised groups, thus assisting in poverty alleviation and the reduction of social and political tensions. Bilateral and multilateral donors have therefore long used credit guarantee schemes as development instruments. Although guarantee schemes may rely on technical assistance in their early stages, they do not involve continued dependency on foreign aid.

In spite of their potential, it remains controversial if credit guarantee schemes are indeed efficient and effective mechanisms to promote small enterprises and to stimulate development. Firstly, it is questionable whether guarantee schemes are the best measure to address the market failures identified in the credit market. Secondly, it is unclear if guarantee schemes accomplish the financial and economic additionality they are designed to achieve.

As to the market failures that guarantee schemes attempt to rectify, more direct ways exist to target asymmetric information, such as credit bureaus. The collateral problem of small firms needs to be addressed directly through reforms of the legal system. Credit guarantees cannot substitute for legal reforms which improve the ability of small enterprises to pledge their assets. On the other hand, it was found that some well-established schemes, e.g. in the Republic of Korea, perform functions similar to those of credit bureaus while reducing collateral requirements for borrowers. Combining the functions of guarantee extension and information gathering may result in significant improvements in the efficiency of both services.

Concerning the ability of guarantee schemes to achieve the objectives pursued, a conclusive answer cannot be given. Guarantee schemes aim to improve the institutional capacity of lenders to service small-scale borrowers. If effective, guarantee schemes would make themselves redundant in the long run. The history of guarantee schemes in Europe, however, shows that this does not seem to be the case. Nevertheless, it was found that some lenders do shift their evaluation criteria from the amount of collateral supplied to dynamic elements, such as an analysis of future cash flows, thereby improving the chance of small enterprises to receive credit.

The claim that schemes achieve financial and economic additionality is difficult to substantiate. Existing evidence suggests that many schemes, particularly in developing and emerging economies, have achieved only limited outreach. To have a significant effect on small firms, business volume would have to be extended, albeit without endangering the viability of schemes. Well-established schemes both in emerging and industrialised countries have been able to reach a large number of small firms. *FOGAPI* of Peru extended 44,000 guarantees in 2001 alone, and the Canadian *SBLA* guarantees an average of 30,000 loans annually. As noted, this latter scheme resulted in the creation of about 66,000 additional jobs in 1995 alone, at a cost of \$1000 to \$3000 per job.

The potential of guarantee schemes to reach their objectives can be constrained by external factors. Without a stable macroeconomic environment and sufficient liquidity in the financial sector, the effects of guarantee schemes will be limited. However, it is precisely in economic downturns that small enterprises develop their potential to act as safety nets. The example of *FOGABA*'s guarantee window for micro enterprises shows that schemes can play a considerable role in assisting this task.

Credit guarantee schemes have had a questionable track record and have been heavily criticised. In order to maximise the potential of guarantee schemes while minimising the costs involved, good practices were identified. The indicators outlined in chapter 3 can serve as guidelines in the design and implementation of effective schemes.

The mutual form of guarantee extension was found to be preferable to the alternatives. European examples show that MGAs are able to reach out to a significant number of small businesses. In MGAs, the initiative to extend guarantees comes from the credit-seeking entrepreneurs themselves. As the examples of Jaipur and Ambur illustrate, external institutions and banks can promote and assist the formation of MGAs and

contribute to their viability as long as local realities are taken into account. MGAs provide the opportunity for small firms to create networks. This is a decisive factor for entrepreneurial development and in overcoming the inherent disadvantages of smallness. In addition, MGAs directly address the problem of asymmetric information, which lies at the core of small firms' financing problems. To reduce asymmetric information, however, it must be ensured that members have influence over each other and can assess each other's operations correctly. This is usually given in associations of the closed type, which comprise enterprises operating in the same field, as in the Italian MGA model.

Due to methodological problems and the high cost involved, there is a lack of reliable and comprehensive evaluations on schemes' performance. Key data available on credit guarantee schemes such as the amount of investments enabled by the schemes, is insufficient to determine conclusively whether the benefits of guarantee schemes outweigh the costs implied. It is therefore essential to attempt to measure financial and economic additionality correctly. At the same time, the costs of servicing businesses not truly in need of guarantees and possible displacement effects on non-guaranteed borrowers must be estimated. Further research is thus needed to assess the efficiency of guarantee schemes in promoting small businesses and ultimately development as well as to identify the factors contributing to their success.

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