



# **Guarantee Funds for Small Enterprises**



*A manual for guarantee fund managers*



By:  
Linda Deelen &  
Klaas Molenaar

2004

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## GUARANTEE FUNDS FOR SMALL ENTERPRISES A MANUAL FOR GUARANTEE FUND MANAGERS

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This manual was prepared jointly by Linda Deelen & Klaas Molenaar

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## FOREWORD

Guarantee funds for small enterprises can make bank finance more accessible for small entrepreneurs. Many viable projects do not get funded because there is no or not enough collateral. As a result no investment is undertaken, and no jobs are created. Guarantee funds can help here. They offer risk-sharing and seek to motivate financial institutions to explore new market segments.

The success of guarantee funds depends largely on their design, i.e. how incentives and sanctions are set and how the fund is governed. Critical are, notably, risk sharing arrangements, eligibility criteria, staffing and internal reporting and control systems.

Another critical condition is, obviously, that the professional staff in a guarantee fund maintains close contacts with clients, i.e. entrepreneurs. This will make banks feel confident that the guarantee fund actually knows more about the enterprise clients and makes a reasoned assessment of the risk involved. The financial landscape should determine the features of a guarantee fund in a particular case.

Not all guarantee funds around the world have reached their objectives. Some of the failures were due to political interferences which made it impossible for guarantee fund managers to adhere to sound financial practices. Other schemes were designed with the unrealistic expectations to upgrade the loan portfolio of banks. Guarantee funds cannot possibly turn a bad investment into a viable one.

The ILO believes that credit guarantee funds have a role to play in redirecting investments towards sectors that are considered important for employment creation and economic growth, i.e. small and medium sized enterprises. Guarantee funds, if properly designed and managed, have shown to boost the small enterprise sector in many countries.

Since 1992 the ILO Social Finance Programme provides training and technical support to credit guarantee funds around the world. In 2000 Social Finance published the first edition of a manual “Making Guarantee Funds Work for Small and Micro Enterprises”. The manual has sold close to 1000 copies and been translated into French, Spanish, Chinese and Russian.

The English original has been recently updated and redesigned by the ILO and FACET BV. As the first edition, this second is addressed to practitioners who run a guarantee fund for small enterprises or who wish to launch one.

I wish to thank Klaas Molenaar, founder of FACET BV, and Linda Deelen, who is the key responsible person for this area of work in Social Finance.

Bernd Balkenhol  
Head,  
Social Finance  
ILO

## INTRODUCTION

### *This chapter:*

- *describes types of small enterprises*
- *introduces credit guarantee funds and how they can facilitate access to finance for small enterprises*
- *discusses what types of small entrepreneurs would benefit from a guarantee fund*
- *presents a short history of guarantee funds*

### **1.1 Small enterprises: engines of development**

All successful companies once started small, with an entrepreneur having a business idea. Some of the small enterprises started today will become pillars of economic growth within the next decade. They are motors for renewal and innovation, places where people meet their aspirations and employ their talents and creativity. Every economy and every generation needs entrepreneurs willing to invest their resources, talents and energy into their business plans.

Small businesses are an important force for employment creation and poverty reduction too. Work in them accounts for an important share of employment in developing countries. In fact, for many people around the world, work in small businesses is their only possibility for a minimum living standard. In transitional economies (former state-run economies changing into market economies) small enterprises have the capacity to absorb at least part of the workforce thrown into unemployment as a result of public sector reform.

But small businesses need a conducive business environment to take full advantage of the opportunities before them. A conducive environment means market access and an advantageous fiscal and regulatory climate. All small entrepreneurs need access to finance to start and expand their business. And one way to facilitate access to finance is through the provision of credit guarantees.

## 1.2 Types of small enterprises

What is a small enterprise? Different people use different definitions. In this manual, we define a small enterprise as any enterprise that employs between 10 and 50 people, has an operating licence from the local authority, and has a focus on profit and growth.

A more complete classification of micro, small and medium enterprises is given in the table below. Such classification should be seen as a continuum – there are, for example, many enterprises with some characteristics of a micro-enterprise and other characteristics of a small enterprise.

**Table 1.1**  
**Classifying micro, small, medium and medium enterprises**

Type of Enterprise	Entrepreneur's objective
<b>Medium enterprise</b> 50-250 employees, operating licence from local authority	Profit/growth oriented
<b>Small enterprise</b> 10-49 employees, operating licence from local authority	Profit/growth oriented
<b>Micro-enterprise</b> 1-9 employees, fixed business premises, family labour	Little orientation to growth and capital accumulation  Stabilisation of income
<b>Income Generating Activity (IGA)</b> Mostly part-time labour Temporary, and sometimes seasonal activities	Not focusing on economic expansion but aiming at additional family income

Although the focus of this manual is on small enterprises accessing finance, credit guarantees can be used successfully for micro-enterprises. What is important is that financial services – and therefore also credit guarantees – are adapted to the true needs and absorption capacity of their clients. From this point of view, it is more useful to classify enterprises by needs rather than size. Such a classification is shown in the following table:

**Table 1.2**  
**Need for financial services amongst different types of entrepreneurs**

Type of entrepreneur	Needs and expectations
<b>Grantworthy</b>	<p>Poor people who undertake basic economic activities for day-to-day survival purposes without making consistent profits. They need financial services that make them less vulnerable, such as savings schemes and emergency loans. The provision of grants instead of loans may be appropriate.</p> <p>Most of the economic activities in this category can be classified as Income Generating Activities (IGAs).</p>
<b>Creditworthy</b>	<p>Entrepreneurs who are able to generate sufficient revenues to repay a business loan, provided there is an appropriate credit methodology adapted to their needs (such as alternative collateral or group formation).</p> <p>Both micro- and small enterprises can fall into this category.</p>
<b>Bankworthy</b>	<p>Entrepreneurs who operate a stable and profitable business and who need a wider range of financial services including different types of loans, payment services and insurance. Many of these entrepreneurs may be able to obtain a bank loan under normal banking conditions.</p> <p>This category comprises both small and medium-sized enterprises.</p>

### 1.3 The role of guarantee funds

A credit guarantee is a financial product that a small entrepreneur can buy as a partial substitute for collateral. It is a promise by a guarantor to pay all or part of the loan if the borrower defaults.

The main target group for guarantee funds are small and micro entrepreneurs who have the necessary repayment capacity but who, for some reason, cannot obtain a bank loan without the support of the guarantee fund. These

entrepreneurs, in other words, are bankworthy, but they lack the necessary collateral and track records.

Guarantee funds are not the only mechanisms which facilitate access to finance. In many parts of the world, other kinds of special credit and financing schemes have been set up to enable small and micro-enterprises to get started or to expand their operations. These services are offered by various kinds of institutions, depending on the types of entrepreneurs being assisted. Poor people who undertake income-generating activities for their immediate survival usually rely on socially-driven finance from non-government organisations (NGOs) or from government. Creditworthy micro-entrepreneurs usually deal with microfinance institutions. Small and medium-sized enterprises normally try to obtain loans directly from banks.

It could be argued that banks and microfinance institutions should be able to deal adequately with the credit needs of small and micro-enterprises and therefore that there is no need for credit guarantee funds. This may be true for some countries, but it depends very much on the unique features of the financial sector in each country. Microfinance institutions have achieved much in their support to micro-enterprises, but they have not always been so successful in enabling their clients to graduate to accessing loans from banks.

In most countries there are at least some small enterprises which require loan products that go beyond what microfinance institutions can offer, whether in loan size, loan term or how the loan product is adapted to individual needs. These entrepreneurs want access to commercial banks but may lack the necessary collateral. This is where credit guarantee funds come in.

**Table 1.3**  
**Types of financial service providers and their target groups**

Type of funding	Grants	Development loans	Commercial loans
<b>Financial service provider</b>	NGOs and socially-driven government organisations	Microfinance Institutions	Banks
Type of entrepreneur	Grantworthy	Creditworthy	Bankworthy
<b>Type of economic activity</b>	Survival activities	Micro and small enterprises	Small and medium enterprises

## 1.4 A historical perspective

The first credit guarantee funds were created in Europe as long ago as 1848. Strictly speaking, they were mutual guarantee associations: groups of entrepreneurs contributed their own funds to provide credit guarantees for each other. Such mutual guarantee associations are still an important vehicle for small enterprise finance in Europe. In some cases they have evolved into fully-fledged financial institutions.

After the Second World War, state-supported guarantee funds played an important role in the reconstruction of the economy in Europe. Especially in the Netherlands and Germany, the small enterprise sector benefited to a large extent from these schemes. In most European countries, state guarantee schemes are still operational today.

In the 1970s and 1980s, a new wave of guarantee fund experiments were tried in developing countries. Many of them were donor-driven initiatives. Some were set up to overcome weaknesses in the banking system or weaknesses amongst small entrepreneurs. Because this was unknown territory, there were many failures. Many development agencies became reluctant to experiment with guarantee funds again.

In the 1990s, however, interest in credit guarantee funds revived. In particular, guarantee funds were created in the transitional economies of Eastern Europe and the former Soviet Union. Many of these have been quite successful.

**Table 1.4**  
**Historical overview of guarantee fund models**

Period of establishment	Major focus	Most prevalent type of guarantee fund
Europe, 19 <sup>th</sup> century	Mutual assistance amongst small entrepreneurs	Mutual guarantee association
Europe and North America, 1950-1960	Reconstruction of small and medium enterprise sector	State-supported national schemes

Period of establishment	Major focus	Most prevalent type of guarantee fund
Developing countries, 1970-1990	Development of small and micro-enterprise sector, agricultural development	State-supported or programme-based
Transitional economies, 1990-2000	Reconstruction, reactivation of small and medium enterprise sector	State-supported or programme-based

Taken together, these four phases of guarantee fund history represent a wealth of expertise and experiences. They also show that there is no blueprint for the most appropriate guarantee fund model. If there is one common thing that these experiences demonstrate, it is that success for a guarantee fund depends on the accuracy and precision with which the guarantee fund is designed and crafted into the existing institutional and financial framework.

## 1.5 The justification for credit guarantee funds

Although some credit guarantee funds operate on a cost-recovery basis, and some even make a profit, most funds receive some kind of public support at some stage. So it is valid to ask: What is the justification for using public funds?

One answer is that credit guarantee funds, through lending to small enterprises, can stimulate growth in economies where resources are not fully employed. Many banks in developing countries are over-liquid but do not put their funds to use because of the perceived high risk of potential borrowers. Guarantee funds can help to put this liquidity into the economy.

Another argument for guarantee funds is the presence of information asymmetries. Banks never have full information about their potential clients' capacity and willingness to repay.

This phenomenon, known as information asymmetry, affects small firms more than large firms. It leads to a relatively low allocation of credit to smaller firms even though small enterprises may represent a healthy economic sector. Credit guarantee funds can rectify this market imperfection.

A third argument in favour of guarantee funds is related to the imperfections in contract enforcement procedures for collateral. The long and costly judicial procedures for seizure of collateral in many developing countries affect small entrepreneurs more than larger firms. This may also result in a too low

allocation of credit to small enterprises, something that guarantee funds can help to overcome.

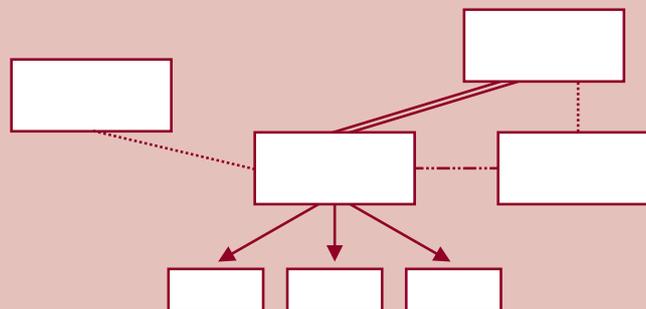
However even taking into account these arguments in favour of guarantee funds, it is not always true that guarantee funds are the best way of dealing with misallocation or under-utilisation of credit resources. Sometimes it may be more effective to use public resources to improve court procedures or to train bank staff. The creation of a guarantee fund may or may not be the best solution – this has to be assessed on a case-by-case basis.

### **Workshop Exercise:**



Prepare a schematic chart of your guarantee fund and the financial landscape in which it operates. The chart should include the guarantee fund, its partners, financiers, competitors and clients. Present your chart to the plenary and discuss the place of your guarantee fund in the financial landscape.

Keep the results of this exercise as you will need them later during the workshop.





## THE ROLE OF CREDIT GUARANTEES

### *This chapter:*

- *explains the stage in the development of a small enterprise when credit guarantees are most needed*
- *discusses the role of collateral to secure loans*
- *presents the conditions under which guarantee funds can operate successfully*

### 2.1 When credit guarantees are necessary

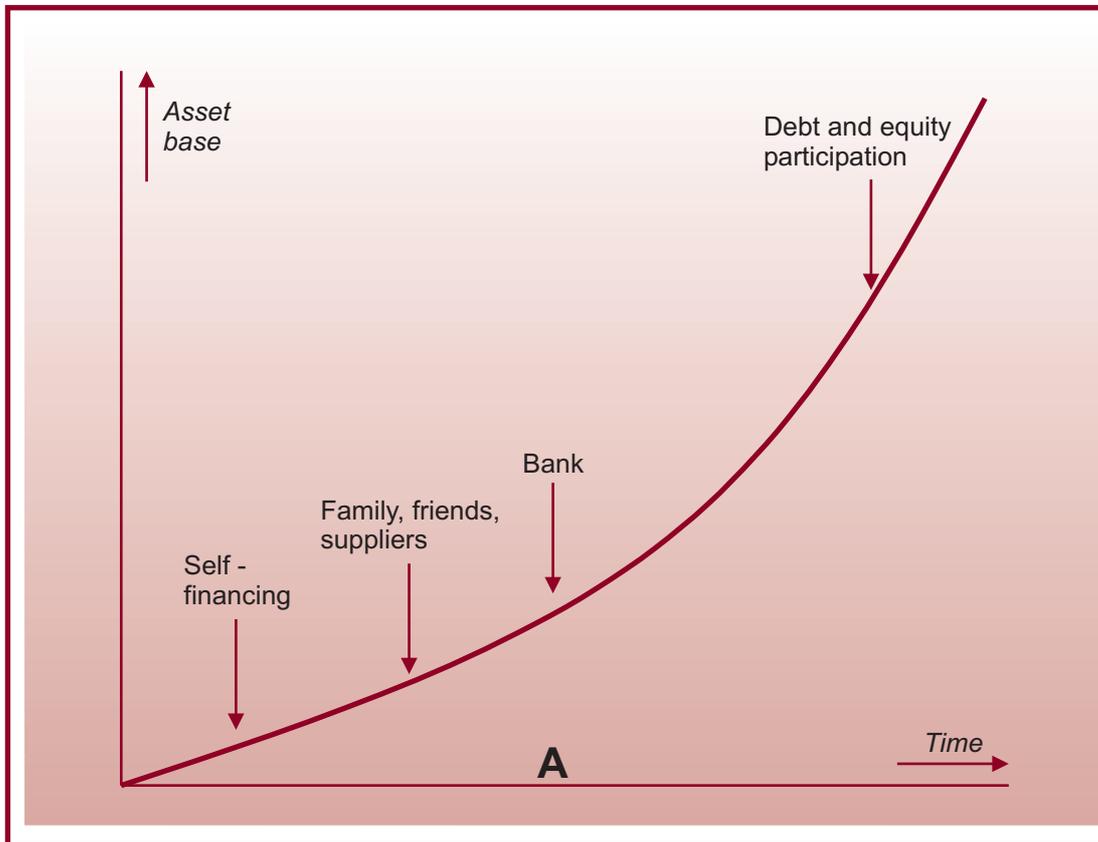
Most entrepreneurs start their businesses with their own financial resources and, of course, their knowledge, vision, drive and ambition. In the beginning – the start-up phase – they tend to rely on loans from family or friends and credit provided by input suppliers. At this stage credit guarantees are not normally needed.

If the start-up phase turns out successful, the entrepreneur will want to make more investments and will also want to maintain enough working capital for the business to provide a reliable and sufficient stream of income. The profits made at this stage are not likely to cover these requirements. But if the entrepreneur tries to obtain a bank loan, he or she will probably be unable to fully comply with the collateral requirements.

This is the stage when guarantee funds come in (shown by point A in the graph below), because guarantee funds are specifically designed to help entrepreneurs obtain bank finance by dealing with the collateral constraint.

Guarantee fund support should be of temporary nature. By the time the entrepreneur has paid back the first loan and applies for a second loan, he or she should have built up the necessary track records and/or collateral to access a loan without the need for a credit guarantee.

**Figure 2.1 Financial structure in the life cycle  
of an enterprise**



## 2.2 Banking principles and the logic of guarantees

Many small entrepreneurs throughout the world do not have access to loans from banks or formal financial institutions because of the lending criteria of these institutions. Banks will not extend credit, even to bankworthy borrowers, unless they are sure they can recover the debt after a default.

Banks normally evaluate credit applications against two basic principles:

1. to safeguard the interest of their depositors (and so not invest in ventures they regard as too risky).
2. to generate an acceptable level of income to cover costs and make a profit.

Why do banks put so much emphasis on collateral? First of all, because collateral shows a commitment from the side of the client to repay the loan. This is a way of screening clients, since clients who are not serious about their repayment obligations will not take the risk of pledging an asset. Secondly,

collateral helps banks to recoup losses in cases of loan default. The losses can at least be partly compensated by the sale of seized collateral.

Avoiding risk is a characteristic of banks as institutions, but it is also a characteristic of the individuals working in them. Individual bank employees tend to opt for lower risk investments because they want to avoid jeopardising their promotions and careers. In fact some banks measure their employees' performances on the basis of realised profit. Bank staff may avoid small operations not only because of the risk but because dealing with small entrepreneurs is relatively expensive, needing more time for evaluation and monitoring. This tendency can be even worse in state-owned and government banks where the same risk-aversion attitudes are reinforced by bureaucratic ways of structuring and regulating operations.

The amount of funds a bank is allowed to lend by the regulatory authorities depends on the extent of the bank's own capital and the risk profile of its credit portfolio. Under-collateralised loans are rated as more risky, and lower the amount of lending a bank is allowed to do. In short, under-collateralised loans decrease profits.

Banks are usually restricted in the types of collateral they can accept. In many countries, Central Bank regulations stop banks from accepting the types of collateral that small firms are able to pledge, such as stocks and receivables. In many developing countries and transitional economies, judicial procedures to seize collateral after loan defaults can take months, if not years. Facing all these obstacles, most banks abstain from lending to small enterprises. Even though they may see that the small enterprise sector is potentially profitable, the obstacles they encounter cause them to stick to lending to their traditional clientele, the medium and large enterprises.

### 2.3 Features of good collateral

What are the features of good collateral as far as banks are concerned?

- Its ownership is easy to verify
- It is easily and cheaply seized
- It cannot be removed
- The costs of converting it into cash or some other desirable asset are low
- If it consists of movable assets, it is relatively cheap to store or manage
- Its value remains relatively stable over time

- If it has a low monetary value, it should have a high and stable personal value to the borrower

Looking at these features, it becomes clear that (with the exception of the last condition), small entrepreneurs, especially low-income entrepreneurs in developing countries, are going to have difficulty providing acceptable collateral. Their quality of collateral is often poor. Sometimes the ownership of the asset is difficult to establish, particularly when land is used as security and systems of title are not formalised. Where there is no formal title, banks cannot accept land or buildings as collateral.

Borrowers might wish to offer personal assets (household goods or sometimes cattle) as collateral. While these may represent great value to the borrower, they are not necessarily good collateral for the banks. Liquidating these assets can result in extremely difficult consequences for the borrower and in socially undesirable situations for the bank.

Stock and small machinery are sometimes used as collateral, but the value of these assets tends to fluctuate. When repossessed they may be costly to store or manage. These assets may also be worth little and be costly to sell.

## 2.4 Conditions for successful guarantee schemes

Experience has shown that guarantee funds are *not* tools to solve the problems of weak entrepreneurship or poorly performing banks. As a rule of thumb, guarantee schemes are only likely to be successful when the four Ps are all present: well-prepared entrepreneurs who present good projects to good performing banks that have professional staff to carry out an evaluation and come to the conclusion that the borrower cannot present sufficient collateral.

A successful loan (and hence a successful guarantee) depends upon the borrower repaying as agreed. Thus it is crucial that the borrower has something at stake. One could say that the more the borrower has at stake, the higher the probability that the guarantee will never have to be called in.

It is general practice for banks to demand from borrowers that they contribute at least 20% of the total project cost – this is in addition to the borrower's collateral! The exact contribution differs from country to country and depends on the internal regulations of banks and the rules of Central Banks. While 20% is the standard, this must be applied with extreme care and prudence – a person with little to no capital who is willing to invest his or her meagre savings might be more trustworthy than a richer entrepreneur who only invests a fraction of his or her capital.

## 2.5 Guarantee schemes as part of a larger programme

In some cases, guarantee schemes are packaged as part of a more comprehensive programme of assistance for small enterprises, along with other business development services (BDS). Such programmes may help entrepreneurs to draft business plans or provide other assistance to the new business venture. The decision to approve or reject an application for a credit guarantee must always be taken independently from the decision to provide other business assistance. Also, the costs of other business development services must not be incorporated in the guarantee fee otherwise there will be price distortions and undue financial burdens.

### *Workshop Exercise:*



In a small group, discuss the following questions. What types of collateral can the clients of your guarantee scheme offer? Are the clients required to pledge collateral? Why (or why not)? Do the clients pledge the collateral to the bank or to the credit guarantee fund?



## GUARANTEE FUND MODELS

### *This chapter:*

- *provides an overview of the various models of guarantee funds*
- *discusses the advantages and disadvantages of different models*
- *provides an overview of the different modalities for guaranteeing loans for small enterprises*

### 3.1 Types of guarantee funds

All guarantee funds have the common purpose of creating greater access to formal financing for promising small enterprises, but there are wide variations in how they are set up and operated. These differences come about because of adaptations to their operating environment. There is no one model that is sure to work better than others. It is always a question of creating the best type of fund for the particular context.

When designing a guarantee fund, one has to take into account the existing financial landscape, the social and cultural conditions, and the prevailing rules and regulations. Then there are parameters like the way the fund is capitalised, how the guarantees are delivered, when the guarantees are delivered, and whose loans are guaranteed. In addition, there are distinct ownership structures.

**Table 3.1**  
**Types of guarantee fund**

Focus	Typology	
How has the fund been capitalised?	Funded scheme	Un-funded scheme
How are the guarantees delivered?	Individual guarantee scheme	Portfolio scheme or automatic scheme
When are the guarantees delivered?	Ex-ante scheme	Ex-post scheme
Whose loans are guaranteed?	Enterprise-oriented scheme	Institution-oriented scheme
What is the ownership structure?	Mutual scheme	Non-mutual scheme

In practice, any particular guarantee fund combines features of the different typologies. The Dutch national guarantee scheme, for example, can be characterised as an un-funded, non-mutual portfolio guarantee scheme in which ex-post guarantees are delivered to enterprises. The International Guarantee Fund based in Geneva, on the other hand, can be characterised as a funded, non-mutual individual guarantee scheme that offers ex-ante guarantees to institutions rather than to individual entrepreneurs.

What follows are some detailed explanations of the different parameters.

## 3.2 Funded versus un-funded schemes

Any institution or organisation wanting to offer credit guarantees has to convince the bank that its guarantee fund has the necessary resources to pay out in cases of loan defaults. Most guarantee funds therefore maintain deposits specifically for this purpose.

A **funded scheme** keeps an amount of money in a bank account or invested in some other way. This fund could come from contributions from the entrepreneur-borrowers, or from sponsoring organisations, or from participating banks. All fees charged for credit guarantees then get added to the fund, while any guarantees paid out decrease the size of the fund.

Not all guarantee institutions deal with the financial responsibility in this way. The Netherlands pioneered what are known as **non-funded schemes**. In these schemes the government assumes financial responsibility for the guarantees offered and meets deficiency payments directly from the government budget – in the case of the Netherlands, the budget of the Ministry of Economic Affairs.

The advantage of non-funded schemes is clear. By not maintaining a fund, the Ministry of Economic Affairs avoids the problems inherent in managing it. Of course only credible public institutions like governments are in a position to offer guarantees without the backing of a special fund. Bodies like NGOs and business associations will only be able to convince banks to accept their guarantees if they can show that they are keeping a sum of money specifically for this purpose.

In an unstable financial landscape, such as exists in some developing countries, a non-funded scheme may lead to 'moral hazard', where perceptions start to affect repayments. The guarantee fund may become perceived by both lenders and borrowers as a governmental entity, particularly when capitalisation happens without follow-up steps to recover losses. Clients may then develop a perception that their loans are guaranteed by the government without repercussions for non-payment, and so they may become less likely to repay their loans.

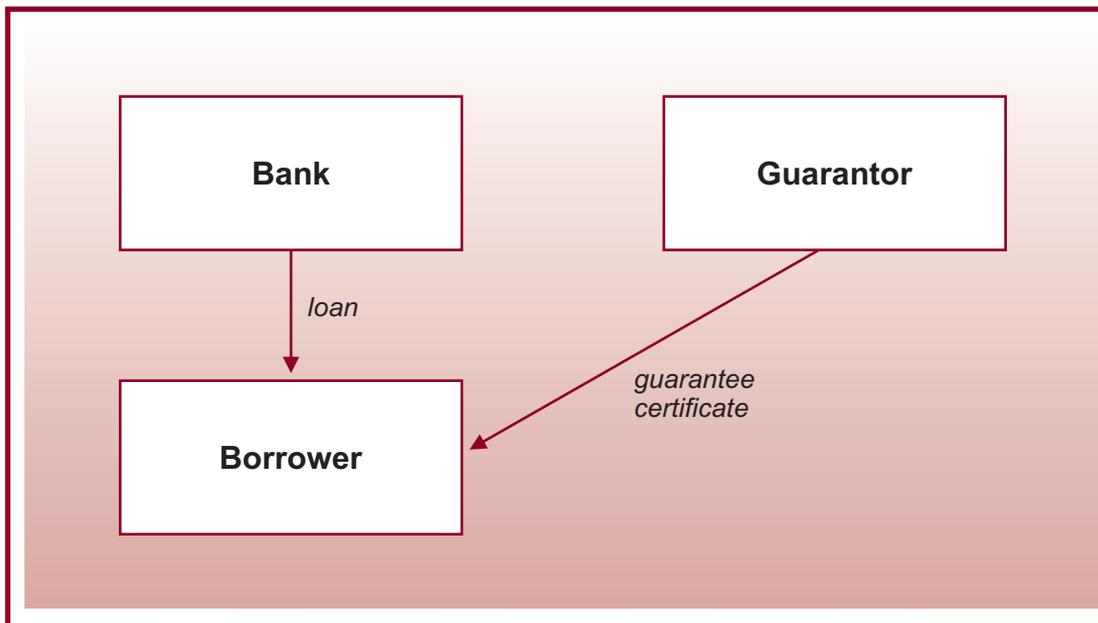
### 3.3 Individual guarantee schemes versus portfolio guarantee schemes

Both individual and portfolio schemes are in common use. The important distinction between them is the way in which their credit guarantees are delivered.

In the **individual guarantee scheme** each and every client of the guarantee fund is individually screened by the guarantor. The guarantee scheme thus has direct contact with the entrepreneurs. Each entrepreneur has to apply for a credit guarantee, and is evaluated before a credit guarantee is granted. Clearly, this is very labour-intensive. It means that each entrepreneur who needs a guaranteed loan is screened twice: once for the loan by the bank and once for the guarantee by the guarantee organisation.

Individual guarantee schemes provide guarantee certificates to each individual client, as shown below.

**Figure 3.1 The individual guarantee scheme**

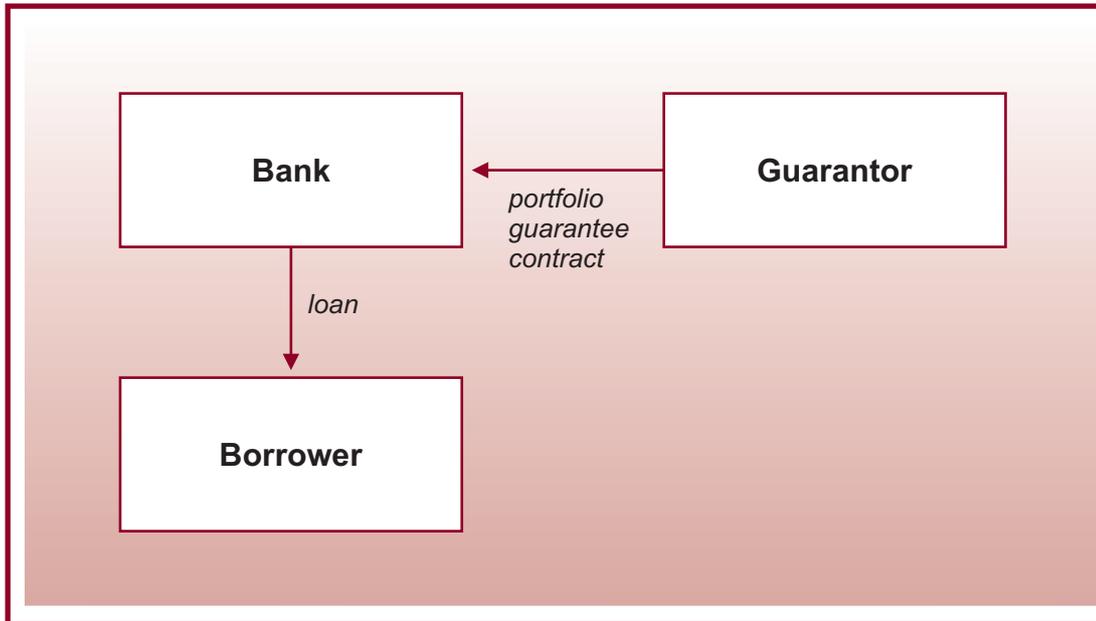


In a **portfolio guarantee scheme**, the guarantee scheme does not look at the credentials of each and every applicant. Instead, it gives the bank permission to attach a credit guarantee to any client that fulfils certain eligibility criteria (for more on eligibility, see Chapter 4). The bank simply informs the guarantee fund, usually on a monthly basis, of the new loans it has approved.

Portfolio guarantee schemes are obviously less labour-intensive for the guarantee scheme than individual guarantees, since screening of clients is done by the bank only. This is an advantage for the guarantee fund, but the disadvantage is that the fund has a lot less control over the quality of its guaranteed portfolio. A portfolio scheme can only work if the guarantee fund trusts the capacity of the partner bank to evaluate the entrepreneurs who apply for a loan.

In a portfolio guarantee scheme, the guarantee scheme does not issue individual guarantee certificates. Instead, the rights and duties of the bank and the guarantee scheme are laid out in a contract between them as illustrated in Figure 3.2 below.

**Figure 3.2 The portfolio guarantee scheme**



The following table summarises the advantages of both models:

**Table 3.2**  
**The advantages of the individual and portfolio models**

Individual model – advantages	Portfolio model - advantages
Complete control of appraisal process	Lower operational costs
Better information for monitoring purposes	Fast

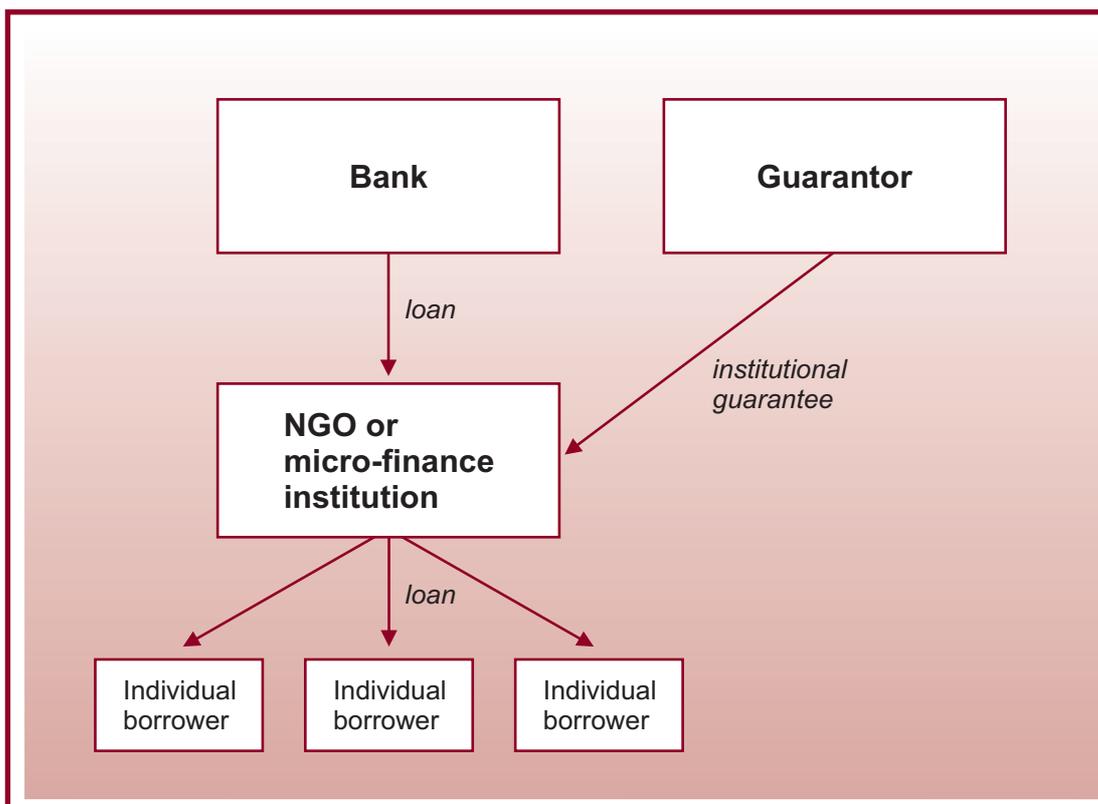
### 3.4 Enterprise-oriented versus institution-oriented schemes

In most guarantee funds, the clients are small entrepreneurs. If an entrepreneur defaults, the guarantee fund pays the coverage on the loan of that entrepreneur. These guarantee funds are known as **enterprise-oriented guarantee funds**.

Some guarantee schemes, however, specialise in guaranteeing loans to NGOs and/or microfinance institutions. Many NGOs and microfinance institutions need to borrow money in order to carry out their activities. Especially when they need loans for the first time, these institutions will have difficulties convincing the local bank of their repayment capacity. The credit guarantees issued by an **institution-oriented guarantee fund** cover loans taken by NGOs or microfinance institutions. If the institution cannot pay back the loan for some reason, the guarantee fund will pay instead.

NGOs and microfinance institutions often need the guaranteed loans they take from the bank for on-lending to their members or clients. The guarantee fund thus indirectly facilitates access to finance for these individuals. For this reason institution-oriented guarantee schemes are sometimes called indirect guarantee schemes (as opposed to direct guarantee schemes that guarantee entrepreneurs' loans directly).

**Figure 3.3 The institution-oriented guarantee scheme**



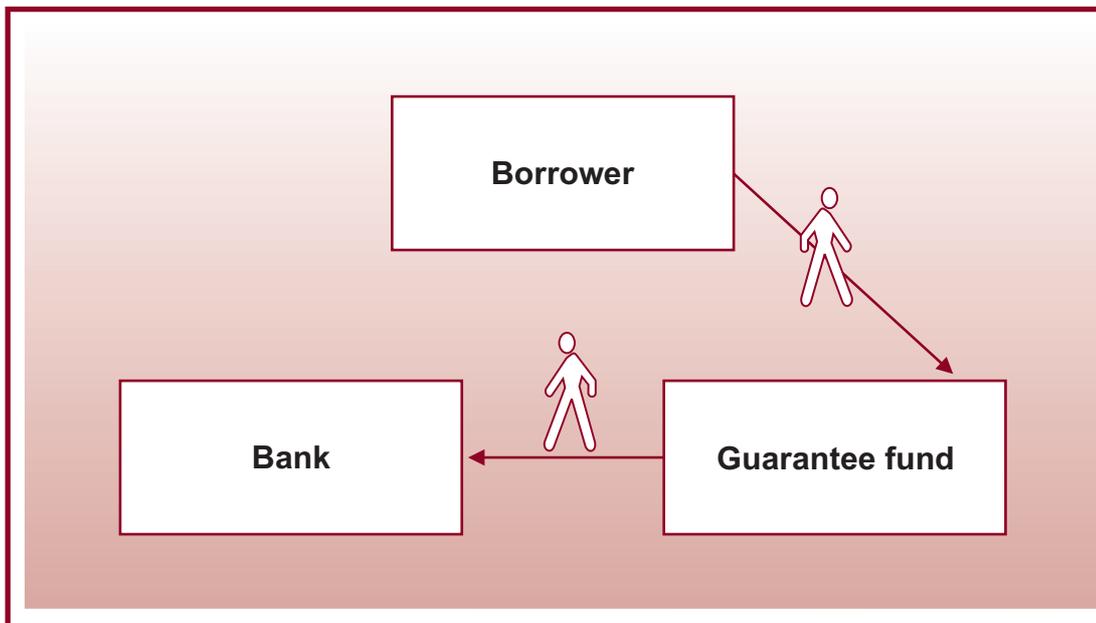
### 3.5 Ex-ante versus ex-post guarantee schemes

Guarantees can be given at two different moments in time, either before the loan application is evaluated and approved by the bank (ex-ante), or after the bank has in principle approved the loan (ex-post).

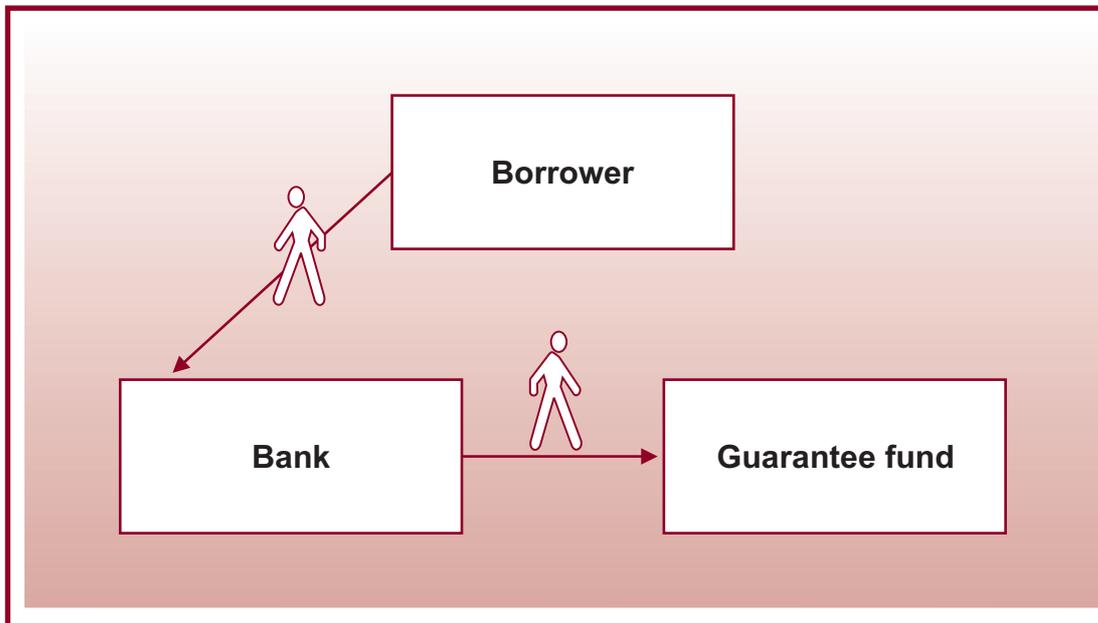
In **ex-ante guarantee schemes**, the client presents his or her project and financing proposal first to the guarantee scheme. If the guarantee scheme approves the proposal, it can issue a letter of intent or a letter of guarantee for the client to a bank (usually the bank will have been identified beforehand). This is done with the explicit understanding that granting a guarantee will not imply that the lending institution will approve the loan. The disadvantage of this approach is that the client will expect the bank to now easily approve the loan application. The guarantee scheme will also be tempted to exercise pressure on the bank to approve the loan.

In **ex-post guarantee schemes**, the bank first evaluates the loan application and sees whether there is sufficient collateral. Once the bank has approved the loan in principle, the client can be referred to a guarantee scheme with the suggestion to apply for a guarantee. Of course the client might still end up without finance since there is no assurance that the guarantee will be offered.

**Figure 3.4 The ex-ante scheme**



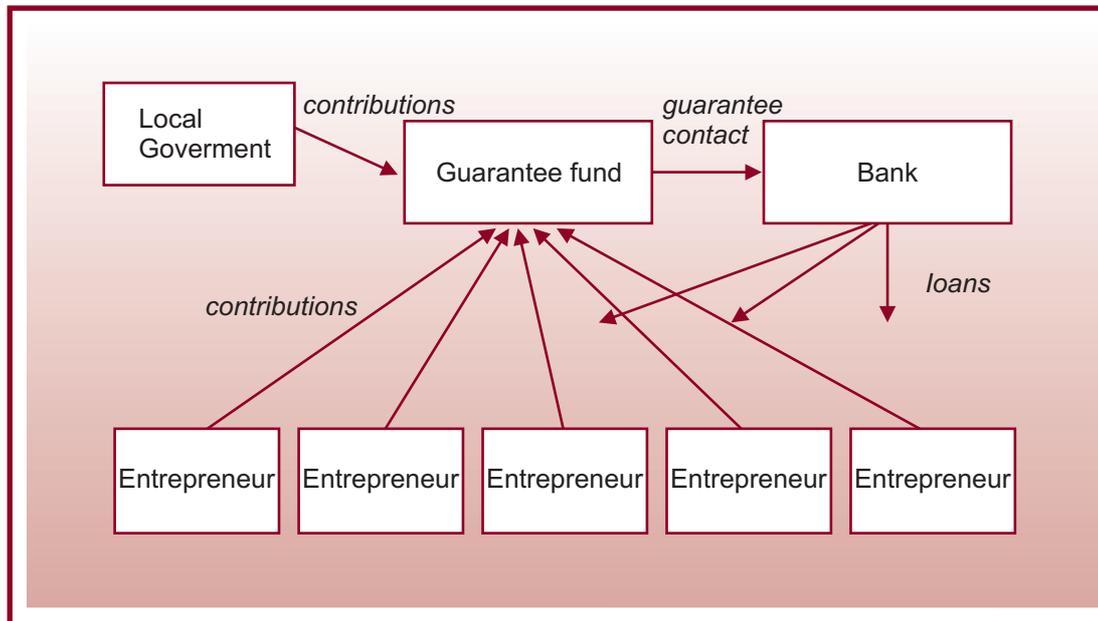
**Figure 3.5 The ex-post scheme**



### 3.6 Mutual guarantee associations

A **mutual guarantee association** is an association set up by entrepreneurs themselves with the purpose of guaranteeing each other's loans. Mutual guarantee associations are common in a number of European countries, where they usually originate from trade associations. The members of a mutual guarantee association contribute to the guarantee fund through shares and fees. The fund is often topped up with contributions from public (local government) agencies.

Well-functioning mutual guarantee associations can have hundreds of members. In countries where mutual guarantee associations are common, they have strong bargaining power with local banks and can negotiate flexible and affordable financial services.

**Figure 3.6 The mutual guarantee association****Workshop Exercise:**

How would you characterise the guarantee scheme you are working with? Does it offer ex-ante or ex-post guarantees? Is it a mutual guarantee association? Having gone through this chapter, do you think the design of your guarantee scheme is optimal, given the context it operates in? Why?



## ELIGIBILITY

### *This chapter:*

- *stresses the importance for guarantee funds to have clear eligibility criteria*
- *presents possible ways of defining eligibility criteria*
- *shows the links between eligibility criteria and financial risk*

### 4.1 For whom has the guarantee fund been designed?

The designers of a guarantee scheme usually have certain policy objectives in mind. The guarantee fund may, for example, be a government initiative to support economic growth in certain sectors. It may be a donor initiative with an employment or poverty alleviation agenda. Or it may come from the entrepreneurs themselves, taking the initiative to guarantee each other's loans from a mutual assistance perspective.

The most common policy objectives are small enterprise development, post-war economic recovery, youth employment, women entrepreneurship, and mutual assistance. In many cases these overall policy objectives will be too broad to work with. They have to be translated into clear eligibility criteria – Who exactly will be eligible to apply for a credit guarantee?

At the design stage of the guarantee fund, market research can help to find out where the unmet demand for loans is most urgent. Market research can identify what types of businesses face the biggest credit gap – credit gap being the difference between obtainable credit and needed credit. Thus rather than focus on “who wants credit?”, it is better for the market research to focus on the combination of “who needs credit and can put credit to work?”.

Once market research has shown which entrepreneurs are in most need of credit guarantees, the guarantee fund can define eligibility criteria. A number of factors should be taken into account here:

- Eligibility criteria are strongly linked to credit risk and default rates. For example, guarantee funds that only guarantee loans to start-up firms are likely to incur higher default rates than those that target established enterprises.

- Eligibility criteria affect operational costs. A guarantee fund that deals with many small borrowers is likely to incur higher operational costs than a scheme that works with fewer and bigger clients.
- Eligibility criteria can introduce co-variant risk (risk to which a considerable part of the clientele is subject). A credit guarantee fund should take care that it spreads its risk over different types of clients with different types of enterprises, if possible in different geographical areas. Avoiding co-variant risk is just another application of the old saying “don’t put all your eggs in one basket”. For this reason many credit guarantee funds exclude farmers.

### Co-variant risk

A co-variant risk is a risk that affects a large number of clients at the same time. Some examples:

- An insurance company is subject to co-variant risk if a large proportion of its clients live in an area where there is a risk of earthquakes.
- A guarantee fund suffers from co-variant risk if a large number of its clients are farmers producing the same crops in the same geographical area, subject to the same weather conditions. If there is a drought, very few of the farmers will be able to pay back their loans.

Guarantee funds should avoid co-variant risk by spreading the risk over different types of clients.

## 4.2 Eligibility criteria for small enterprises

Eligibility criteria can be formulated in different ways. They are usually based on a combination of the following variables:

- type of entrepreneurs
- sectors in which the enterprises are active
- size of enterprises according to sales turnover
- size of enterprises according to total investments
- size of enterprises according to number of people employed
- size of enterprises according to total fixed assets

**Table 4.1**  
**Examples of eligibility criteria**

Country	Name of guarantee fund	Eligibility	Further criteria
Brazil	SEBRAE	micro and small businesses	MSEs as defined by law
El Salvador	POGAPE	small businesses	fixed assets < USD 110 000
Slovakia	SCGS	newly established businesses	employees < 25
Sweden	ALMI	start-ups, women entrepreneurs, young entrepreneurs	
India	YCO	self-help groups	
Mali	PDAP	farmers	
Croatia	UNOPS/ UNDP Rehabilitation Programme	displaced people and returnees	

Generally, guarantee funds for small entrepreneurs back productive loans and not loans for consumption. Their aim is to promote enterprise development. So when eligibility criteria are formulated, it must be clear that they are intended to support enterprises that generate income.

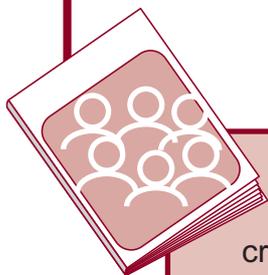
Some guarantee schemes set their eligibility criteria indirectly. Instead of including or excluding enterprises of a certain size, they offer minimum or maximum guarantee amounts. Their assumption is that large enterprises will not be interested in small guarantee amounts – an assumption that is not always correct!

### 4.3 Eligibility of NGOs and microfinance institutions

Institution-oriented guarantee schemes that provide credit guarantees to NGOs or microfinance institutions also need eligibility criteria. These should include what types of institutions can apply for credit guarantees. Most institution-oriented guarantee schemes apply eligibility criteria related to:

- the legal status of the NGO or microfinance institution
- the activities of the NGO or microfinance institution
- the geographical coverage of the NGO or microfinance institution

#### *Case study: Eligibility for ACCION International's Bridge Fund*



Some institution-oriented guarantee schemes only provide credit guarantees to NGOs or MFIs within their network. ACCION International, for example, which operates in Latin America, has a Bridge Fund that provides credit guarantees to its affiliates and associated programmes. ACCION affiliates can benefit from the whole ACCION support package, which includes credit guarantees, equity participations and technical assistance. ACCION International does not have clear eligibility criteria for access to the Bridge Fund. But it does ensure that its affiliates are regularly rated using the ACCION “camel” rating system which measures the affiliate’s capital adequacy, asset quality, management, earnings and liquidity. In this way ACCION International makes sure that it has a healthy credit guarantee portfolio.

## RISK SHARING

### *This chapter:*

- *recommends risk sharing arrangements between banks and guarantee funds*
- *explains the link between risk sharing arrangements and the value of the assets pledged by borrowers*
- *introduces the concept of “line of risk” and stresses the importance of guarantee funds assuming the subsidiary risk*

### 5.1 Why risk sharing?

In any loan scenario it is best for all parties involved to have something at stake. In this way there will be incentives for the lender, the borrower and the guarantee fund to ensure that the risk of loss is minimised. A lender with something at stake will be motivated to screen loan applicants carefully, follow up loans diligently and initiate legal actions when appropriate. A guarantee fund should therefore insist that the lender takes some of the risk. Successful guarantee funds refrain from providing 100% risk coverage to the lender.

What is the exact percentage of risk that the guarantee fund should take on for itself? This depends on a number of parameters:

- The value of the assets that borrowers can pledge as collateral
- The costs of liquidating the assets pledged as collateral
- The delivery mechanism of the guarantee fund

Of course the borrower must also take a substantial percentage of the risk. In this chapter we discuss supplementary guarantees, where the guarantee fund adds to the borrower’s collateral, rather than guarantees that replace the borrower’s securities.

## 5.2 What can the borrower offer as collateral?

Banks will not lend if the amount to be borrowed has not been guaranteed properly. Borrowers can offer collateral in the form of business assets, personal property, or pledges by third parties such as relatives and friends. The monetary value of these assets (both at the moment of borrowing and over time) has to be evaluated to verify that they cover the amount borrowed and to also verify that, if the borrower fails to repay his/her loan, they can be liquidated.

Valuation of the client's collateral is extremely important, since it determines the precise amount of the guarantee required. There are two main issues in valuation:

- Who determines the value of the collateral that the borrower is pledging? Does this person have the right skills and qualities to effectively estimate the real value of the goods pledged?
- How is the value determined?

The value of any type of collateral has to be determined by market prices and by the willingness of the market to actually purchase the goods when put up for sale. *Collateral that cannot be converted into cash is of no value at all.*

For centuries banks have been valuing assets pledged as collateral, and their experience has culminated in some generally accepted standards. These are summarised in Table 5.1 below. Of course these standards differ from country to country and the values presented here serve only as indications.

**Table 5.1**  
**Standards for valuating collateral**

Type of asset	Most common applied % to set value	Comments
Land in residential area (personal or business)	100% of market value at moment of valuation	Verify what town plans indicate
Buildings in residential areas (personal or business)	60-90% of market value at moment of valuation	Verify what town plans indicate
Land in rural areas	0 or 100% of market value at moment of valuation	Verify whether land can socially be seized and liquidated
Buildings in rural areas	0-70% of market value at moment of valuation	Verify whether land can socially be seized and liquidated
Life insurances	100%	If documents are handed over
Business assets – heavy machinery	60 to 80% of purchase value if new	If properly registered
Business assets – light machinery	40 to 60% of purchase value if new	
Transportation equipment (cars, trucks)	50 % of purchase value if new	If ownership documents are handed over
Business assets (computer equipment)	Up to 30 to 40% of purchase value if new	
Stock (raw materials)	Up to 30 % of stock value	If in high demand in market
Stock (finished products)	Up to 60% of book value	If placed in bonded warehouse

Type of asset	Most common applied % to set value	Comments
Debtors	Up to 90%	If properly / officially invoiced and invoices and claims handed over to factor
Personal assets (gold jewellery)	Up to 60%	If handed over and stored by lender
Third party guarantees	To be determined ad hoc	Depending on type of assets that support the third party guarantee

### What is a reasonable level of security?

When a lender and a guarantee fund negotiate a risk sharing arrangement, they have to agree on a reasonable level of total coverage. Bankers and financiers usually want 100% risk-free lending. They demand collateral at least equal to 100% of the value of the principal amount borrowed. In some countries banks even demand 200% or 300% coverage of the loan amount. They achieve this by demanding collateral up to two or three times the value of the loan or by assigning a very low value to the assets pledged.

## 5.3 Liquidating collateral

Seizing and liquidating assets is probably the most cumbersome aspect of lending, and it is an aspect which is sometimes overlooked. Very often it is socially difficult for a lender to seize assets, especially if the lender and the borrower are members of the same community. It may also be politically difficult for lenders to seize the goods of low-income entrepreneurs. Most banks like to maintain the image that they serve the poorer segment of society, and they don't want that image to be shattered by negative media coverage when they seize assets from poorer clients.

There are two issues to take into consideration when liquidating collateral:

- *The legal system (formal and traditional).* Is it possible, in a reasonably short period of time, to seize the assets that have been pledged? The answer depends on the legal or bureaucratic process that has to be followed. In some situations the process is cumbersome and time-consuming. It can become even more complicated in cases where the population adheres to traditional juridical patterns, for example if a village chief can block the seizure of assets. On the other hand, traditional systems can work in favour of the guarantee fund and/ or lender, especially if a good relationship has been built up at the local level.
- *The social-cultural situation.* Sometimes a bank or guarantee fund may find itself in a situation where assets seized cannot be sold, or can only be sold with great difficulty. The bank may find itself faced with a community acting in solidarity, who will only purchase the assets for a token amount and perhaps even refuse to let outsiders acquire them. This can happen in areas with a very strong social cohesion.

## 5.4 Risk sharing and the delivery mechanism

Risk sharing arrangements must take into account the delivery mechanism of the guarantee scheme – meaning the division of responsibilities for loan appraisal, loan follow-up and recovery.

- For *individual guarantees*, the share of risk covered by the guarantee fund usually ranges from 60% to 80% of the unsecured part of the loan (the “gap” – see Table 5.2). Under an individual scheme, the guarantee fund can accept a relatively high degree of risk because it screens all borrowers individually.
- Under an *automatic/portfolio guarantee scheme*, there are two options:
  - 1) The guarantee fund demands that the lender absorbs a percentage of the total portfolio outstanding as the lender’s own risk. This is often set as a maximum of 5% of the average portfolio outstanding, and can be determined on an annual or semi-annual basis. The advantage of this system is that a bank will be careful in assessing clients since it runs the first risk; and the guarantee fund will be careful in referring clients to the lender since it will have to absorb the risk in full once the limit of 5% has been passed. (The 5% is based on the maximum loss rate that any official in a bank may run without jeopardising his/ her career – this may differ for different banks and countries).

- 2) The guarantee for any loan under the portfolio guarantee is set automatically as a maximum of 50% or 60% of the loan amount, irrespective the valuation of the assets. 50% of the risk may seem like a small proportion for the guarantee fund to accept, but one needs to bear in mind that the lender has the full right to extend loans without prior referral to the guarantee fund. This system can speed up procedures but it means that the bank can cover itself extremely well when borrowers have sufficient assets to pledge as collateral. Hence it is important for the guarantee fund to monitor the practices of the partner bank(s).
- Mutual guarantee funds sometimes guarantee up to 100% of loans and carry out all the responsibilities of the lender. This is possible because of the different ownership structure of mutual guarantee funds which allows them the unique ability to guarantee a high percentage of loans without reducing the willingness to repay amongst borrowers/members.

For new guarantee funds, it is important not to start with too high a percentage of risk coverage. Once a given percentage of coverage has been granted, lenders will most likely expect it as a norm and will be very reluctant to renegotiate a lower percentage.

From time to time the level of risk coverage should be reviewed. If a lender has consistently extended poorly performing guaranteed loans under an automatic guarantee contract, the guarantee fund can and should lower the percentage of coverage on future guaranteed loans. Alternatively, it could increase its fees.

**Good practice:** The percentage of risk covered by a guarantee fund has to be carefully negotiated with the lender. Lenders are unlikely to find an offer of less than 50% risk coverage for individual guarantees attractive, as they have to undertake the loan appraisal, follow up and recovery of loans. This would be unacceptable to them without a reasonable guarantee.

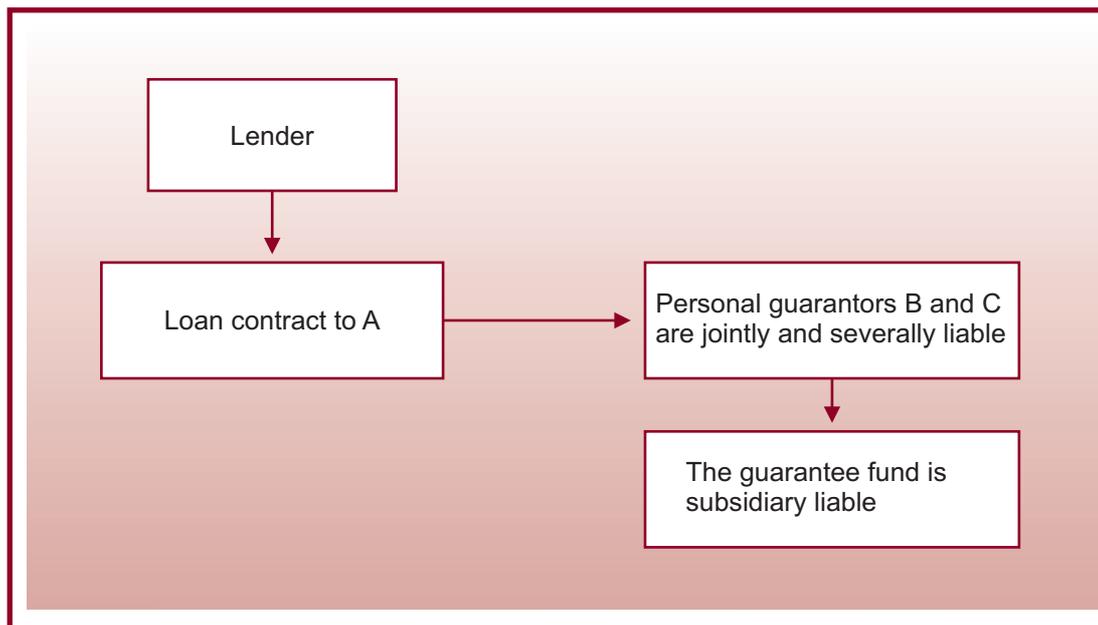
If the guarantee fund offers more than 80% coverage, it could create a dangerous moral hazard for itself. Lenders might lose their incentive to take the necessary steps to ensure that the borrower repays, as they know they can collect the repayment from the guarantee fund.

Recommended rate : about 3% to 5% loss rate – calculated over the average outstanding guarantee amount on an annual basis – to be absorbed first by the bank, is recommended as an acceptable limit for portfolio guarantee schemes. This rate should be in line with the internal loss rates that middle management is allowed to incur without having their promotion opportunities jeopardised.

## 5.5 The line of risk

The line of risk is defined as the order in which the lender claims collateral/guarantee from the different parties involved in the loan. This is illustrated below.

**Figure 5.1 The line of risk**



In the diagram above, the lender has a loan contract with the borrower. The borrower may be solely liable or it may be that others, in addition to the borrower, are standing surety. In the event of default, the lender and the guarantee fund have to be very clear about the order in which the lender collects collateral. The lender should be required to first attempt to obtain collateral from the borrower and all those standing surety who are jointly and severally liable for the borrower's debt. Only then can the lender turn to the guarantee fund for any outstanding debt. The guarantee fund is subsidiary liable.

Establishing the line of risk is crucial for a number of reasons:

- If the lender can collect from the guarantee fund first, he will lose the incentive to collect from the borrower and from others standing surety.
- If the lender is forced to pursue the borrower for collateral first, the lender will be required to institute legal proceedings. A judge or magistrate will determine whether the loan has been disbursed correctly, whether the contract was in order, and what the actual outstanding debt amounts are.

This saves the guarantee fund from having to review these issues itself. It also removes many of the problems that commonly arise regarding the validity of the loan contract or any of its clauses.

### 5.6 The size of the guarantee

The contract between the lender and the guarantee fund has to state clearly the exact amount for which the guarantee fund is liable in case of loan default.

The most common way of defining the liability is as a fixed percentage of the unpaid part of the principal, plus interest payable at the moment the guarantee is called by the lender.

Sometimes the liability is defined as the sum of three elements, the fixed percentage of the unpaid part of the principal, plus the interest payable, plus the penalty interest accrued, at the moment the guarantee is called by the lender. The covering of penalty interest can substantially increase the liability of the guarantee fund, so this method is not recommended.

Usually the percentage of the risk shared by the guarantee fund remains the same throughout the loan term. The liability of the guarantee fund therefore decreases with the rhythm of loan repayments. But this can be considered contradictory to the principle that the bank, over time, should absorb gradually a little more risk. It is also contradictory to the reality that the borrowing enterprise will have built up more assets over time while developing its business. To counter this, some guarantee funds set a fixed pattern to let the guarantee diminish over time.

The guarantee scheme of IntEnt in the Netherlands decreases the amount guaranteed gradually on a quarterly basis, irrespective of the repayment behaviour of the borrower. The initial guaranteed amount is calculated as a percentage of the principal plus the interest to be paid over time at the moment of signing the loan agreement. An example of how the guaranteed amount is calculated is shown in the table below.

**Table 5.2**  
**Calculating the Guarantee**

Item	Value in €
Total investment required/ planned	€ 10.000
Own contribution	€ 2.000
Subordinated loans (unsecured)	€ 3.000
Unsecured loans	€ 1.000
	<b>€ 6.000</b>
To be financed by third parties	€ 4.000
Securities acceptable	€ 2.000
Gap	€ 2.000
Loan principal	€ 2.000
Accrued interest over xx period and with xx % interest	€ 360
Total to be guaranteed	€ 2.360
Risk absorption by the guarantee fund	80%
Guarantee amount	€ 1.888

Besides all the factors already mentioned, a guarantee fund must decide on the maximum amount to be guaranteed per individual case. This amount is determined by the credit needs of the clients of each particular guarantee scheme.

## 5.7 The valuation of the guarantee

Central Banks determine standards for evaluating assets pledged as collateral. They also determine the relative value of guarantees offered by guarantee funds. The form in which these guarantees are offered is a determining factor in

their valuation. Irrevocable letters of guarantee issued by formal banks of good reputation are normally valued at 100% of their face value. In cases where the guarantee is in the form of a letter issued by a non-banking institution, the value can be different, and is mainly determined by the reputation and credibility of the issuing institution.

### **Guarantees have to be liquid**

Guarantee programmes may be set up and designed with all good intentions, but they must be able to meet the requirement that the lender will be in a position to obtain sufficient cash to meet its depositors' requirements at any time. Hence any guarantees offered must also have a relatively high liquid value. No guarantee system can be set up without the assurance that the lender can liquidate the guarantees in order to meet the depositors' demand. In cases where banks absorb part of the risk (as part of the overall agreement made with the guarantee fund) they need to make special provisions for this as well. No bank can be expected to give out loans without such provisions.

### **Workshop Exercise:**



What risk sharing arrangement(s) exist in the guarantee scheme you are familiar with? What is the position of your guarantee scheme in the "line of risk"? Having gone through this chapter, do you think the guarantee scheme assumes too much or too little risk? How would you correct this situation?

## SETTING THE SIZE OF THE GUARANTEE FUND

### *This chapter:*

- *analyses the factors which determine the size of the guarantee fund*
- *discusses funding modalities for different types of guarantee funds*
- *explains the effect of leverage*

### 6.1 Factors that determine the size of the guarantee fund

How large must a guarantee fund be? There are various factors that determine the size. The more important ones are:

- The actual and anticipated demand for guarantees
- The type of guarantee fund being chosen
- The funding available
- The leverage effects

These factors are each discussed in detail below.

### 6.2 The demand for guarantees

Is a guarantee fund needed? And will it be used? The answers depend on both the small entrepreneurs themselves and the participating banks.

The demand among small entrepreneurs is determined by four questions:

- Are there good entrepreneurs with good investment plans who cannot obtain loans from banks because of lack of collateral?
- Are these entrepreneurs willing to spend time and energy presenting their plans to a guarantee fund?

- Are these entrepreneurs willing to pay for guarantees?
- Are there enough of such clients to warrant the creation of a guarantee fund?

The demand among banks is determined by three questions:

- Are there banks with well-trained staff and well functioning procedures interested in serving small entrepreneurs?
- Are these banks reluctant to assist small entrepreneurs because of lack of collateral?
- Are they willing to work with a guarantee fund and accept the extra costs of additional procedures?

Quite often a bank says that it will participate in a guarantee scheme but then fails to make real use of the fund. The cause is usually to be found in the attitude of bank staff. Even if management has agreed to cooperate with a guarantee fund, the people at operations level might be hesitant to expose themselves to what they perceive as higher risks. Trained to accept real collateral and seek for real coverage, they tend to consider the guarantee mechanism not acceptable for various reasons:

- The guarantees are not seen as real collateral
- They do not like the risk sharing aspects
- The procedures to follow are seen as time-consuming and costly
- They have a lack of confidence in the ability of the guarantee fund to pay out the guarantees

### 6.3 The type and size of the guarantee fund

The type of guarantee fund chosen determines its size to a large extent. Let us consider the types of guarantee funds described earlier:

- individual guarantee schemes versus portfolio guarantee schemes
- enterprise oriented schemes versus institution-oriented schemes
- funded schemes versus un-funded schemes
- mutual guarantee associations

*Portfolio guarantee schemes* are attractive if participating banks are willing to assist relatively large numbers of clients. In the start-up phase the size of the guarantee fund per participating bank should be at least 40 times the size of the

average guarantee per client. If the available amount is less than this, the bank will probably argue that the extra administrative costs are too high in relation to the extra business gained.

*Individual guarantee schemes*, most of the operational costs are borne by the guarantee fund rather than by the participating banks. A small individual guarantee scheme can be started with resources of 30 to 50 times the size of the average guarantee per client.

*Institution-oriented guarantee schemes* offer guarantees to NGOs and microfinance institutions. In the first year of their existence, institution-oriented schemes usually provide guarantees to a limited number of NGOs and microfinance institutions only. The start-up fund can be as low as 5 times the average guarantee size per client.

*Non-funded schemes* do not need start-up capital since the losses are covered directly from the budget of the guarantor. However the funding for losses has to be ensured. Backing must be guaranteed from a strong partner, which is usually the government.

*Mutual guarantee funds* can start with a relatively small fund for their first members. These funds can only operate effectively if they attract shares and fees from at least 200 members in addition to contributions from local sponsoring institutions.

**Table 6.1**  
**Factors influencing type and size of funds**

Type of Fund	Min. starting amount	Growth factors	Consolidated stage
Portfolio scheme	40 to 60 times the average guarantee per client and per participating bank	Determined by portfolio growth per participating bank	Determined by the capacity of participating bank and the capacity of funding partners
Individual scheme	30 to 50 times the average guarantee per client	Determined by demand from clients	Determined by capacity of guarantee fund and the capacity of funding partners

Type of Fund	Min. starting amount	Growth factors	Consolidated stage
Institution-oriented scheme	5 to 8 times the average guarantee per client	Determined by demand from clients	Determined by capacity of guarantee fund and the capacity of funding partners
Non-funded scheme	None	Determined by the capacity of participating banks and demand from clients	Determined by the maximum loss the funding party wishes to absorb per annum
Mutual scheme	Relatively low amount for the first members	Based on the membership	Limited by the contributions by the entrepreneurs and other funding partners

The size of the fund is furthermore determined by the maximum amount that it is willing to commit for each individual guarantee in relation to the funds available. The higher this percentage the more vulnerable the fund will be. If it is too high, even a few single claims can have a considerable impact on the size and the relative loss rates. A recommended maximum per client is no more than 5% of the value of the fund.

### 6.4 Possible sources of funding

Funding for a guarantee scheme can come from different sources, each offering its own particular possibilities, advantages and disadvantages.

**Table 6.2**  
**Sources of funding**

Source of funding	Most common model supported	Advantage	Funding limitations
Government	Non-funded portfolio schemes	Losses paid directly from government budget	
Central Bank	Individual and portfolio schemes	Credibility with banking sector	
Development agencies and donors	All type of schemes	Innovative approaches possible	Mainly ad hoc funding
Banks	Individual and portfolio schemes	Experience Involvement of banks Outreach	Only open for participating banks
SME promotion agencies	Individual schemes	Involvement and experience with sector	Limited funding for expansion
Small entrepreneurs	Mutual schemes	Involvement and experience with sector	Limited funding for expansion

The most common ways in which guarantee schemes are capitalised are:

- *Capitalisation by central banks.* This type of capitalisation is generally perceived by borrowers as governmental, which may create a moral hazard with regard to loan repayment. In these funds financial sustainability is frequently not an issue. Political and socio-economic factors are the key elements in their management and evaluation.
- *Capitalisation by banking institutions participating in the scheme.* These schemes tend to prioritise financial sustainability as opposed to other objectives. This model of capitalisation enables the guarantee fund to

negotiate a better leverage with each participating bank, and to benefit from competition, with greater flexibility for terms and conditions.

- *Capitalisation by banking and non-banking institutions participating in the scheme, including SME promotion agencies, ministries, chambers of commerce, and associations of small entrepreneurs.* These schemes may consider both financial sustainability and other objectives as indicators to evaluate the performance of the fund, especially if representation of borrowers (the final users of the guarantees) is prominent.
- *Capitalisation by private and public organisations at the national level, counter-guaranteeing local guarantee funds or co-guaranteeing local banks together with local guarantee funds.* This is a more sophisticated model which allows a greater division of risk but tends to multiply the transaction costs.

### **Workshop Exercise:**



Describe the capitalisation of your guarantee fund. Explain the advantages and disadvantages of these arrangements for your guarantee fund.

Guarantee funds can borrow from third parties. How this is done depends on the financial structure of the guarantee fund, the return on its investments, and the risk profile of its portfolio.

### **Financial structure**

If the guarantee fund is endowed with a strong equity base, it may be able to borrow on the capital market. But the question then arises how it can guarantee its loans. Using the portfolio as collateral is a rather risky operation – in any case it will be difficult to estimate the value of the portfolio, and even more difficult to liquidate it. The fund must therefore pledge other assets or obtain counter-guarantees from development agencies, central banks or government.

### ***Return and interest rates***

Borrowing from third parties is also limited by the rate of interest that the guarantee fund can afford to pay. The guarantee fund's returns are generated from the guarantee operations (its guarantee fees, which are normally around 2% of the outstanding guarantee amounts) as well as the return on its investments of unused funds in the capital market. Because unused funds should not be invested in high-risk operations, these investments will have a relatively low return. Thus the total returns for guarantee funds are not very high, and this limits the possibilities of borrowing from commercial lenders.

### ***Risk profile***

Lenders to guarantee funds will base their decisions on the assessment of the risk profile of the portfolio of outstanding guarantees. Such assessment is rather subjective and cumbersome. It is difficult to evaluate the quality of the portfolio and to interpret the risk. Even when the historical data shows a low loss rate, the risk is also influenced by the leverage applied (see below) at any particular time.

## **6.5 Leverage**

Guarantee funds do not create money. But they can persuade banks to move funds to small enterprises. Without the guarantee fund this might not be done, since the banks may consider the risks too high. Thus the guarantee fund can act as a lever and stimulate the banks to channel more funds to the small enterprise sector than they would normally have done.

Leverage quantifies how much money is likely to be redirected to small enterprises because a guarantee fund is in place. It is expressed as a ratio showing how much can be lent to small enterprises because of the existence of the guarantee fund. Leverage can be defined as:

Leverage =  $\frac{\text{the amount of loans extended}}{\text{the capital of the guarantee fund}}$

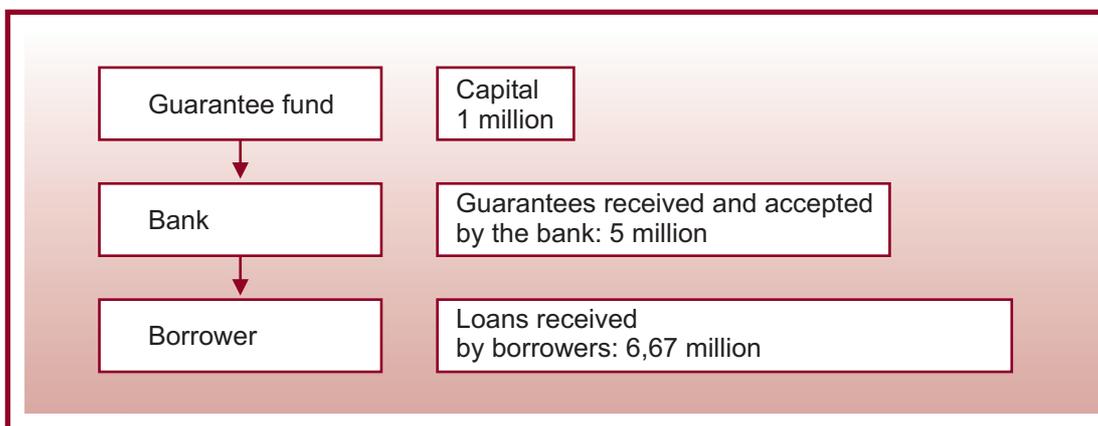
### Calculating leverage: an example

A guarantee fund has a capital of 1 million Euro. Experience over a number of years has shown that the average loss rate on guaranteed loans extended by banks to small entrepreneurs is not more than 20%. Thus for every 100 Euro loaned, not more than 20 Euro is lost. This means that banks can safely extend loans up to 5 times the size of the guarantee fund and still be 100% covered. So with a € 1 million guarantee fund, a total of € 5 million of loans can be guaranteed even with a 100% risk coverage by the guarantee fund. The leverage is then expressed as 5 million/1 million = 5.

This leverage can be further increased if the banks agree to cover some of the loan risk themselves. Continuing the same example, let us assume that the banks cover 25% of the loan risk. The € 5 million guaranteed loan amount would only represent 75% of the total amount of loans that can be extended, so the banks will be able to extend a total loan amount of € 5 million / 0.75 = € 6.67 million. Of the € 6.67 million of loans extended, € 5 million (75%) is covered by the guarantee fund while € 1.67 million (25%) is covered by the banks. The total leverage is therefore 6.67 million/1million = 6.67.

The economic effect of a guarantee fund is even more impressive if we take into consideration the fact that bank loans normally do not cover the total investment by small enterprises. Suppose in this example that the loans represented only 60% of the total investments made by entrepreneurs and that these investments would not have been possible without the credit guarantees. The amount invested would be € 6.67 million/0.60 = € 11.12 million. In other words, with a € 1 million guarantee fund, a total of € 11.12 million of investment can be made possible.

**Figure 6.1 Leverage**



## 6.6 What are desirable leverage rates for guarantee funds?

Any guarantee fund that provides a level of leverage below 1:1 is failing in its mission. It would be better off lending its funds directly to targeted borrowers, without the additional transaction costs of issuing guarantees. Some guarantee funds only attain a leverage of 2:1 or 3:1. This may indicate that banks expect a high default rate and fear that the guarantee fund will not be able to meet its obligations.

The higher the leverage, the greater the achievement of the guarantee fund. However, the default rate has to be taken into account before determining the most appropriate and negotiable level of leverage. The guarantee fund must always be in a position to meet its obligations, but ideally not much more than that. Well-functioning guarantee funds attain leverage rates of 5:1 to 10:1.

It is normal for guarantee funds to show low leverage rates during their early inception period. As they and their participating banks gain experience, much will be learned about the performance of the users of the guarantees.

In summary, a guarantee fund should monitor its leverage for two reasons:

- To ensure that it is maximising the benefit that it provides as shown by the overall value of loans it guarantees.
- To ensure that its level of leverage is related to its anticipated level of claims and to its resources.

*Good practice:* Guarantee funds should assess their achievement more by the volume of credit made available to small enterprises through the guarantee facility than by the returns on their investments. After three years of activity a guarantee fund should reach a leverage of 2:1 or 3:1 and after five years, this should reach 5:1.

### Workshop Exercise:



In small groups, discuss and compare the leverage rates of different guarantee funds with which you are familiar. Discuss whether the levels achieved appear reasonable. If they do not appear reasonable, suggest ways and means to improve them.



# OPERATING PROCEDURES AND PROCESSES

## *This chapter:*

- *describes the life cycle of a guarantee from initial application to recovery of losses by the guarantee fund*
- *describes practices and procedures that increase the effectiveness and sustainability of a guarantee fund*

## 7.1 Application procedures

In a portfolio guarantee scheme, entrepreneurs do not have to apply for a credit guarantee directly, if they fulfil the bank's criteria. But in individual guarantee schemes entrepreneurs have to apply explicitly for a credit guarantee. In this chapter we look at the application procedures.

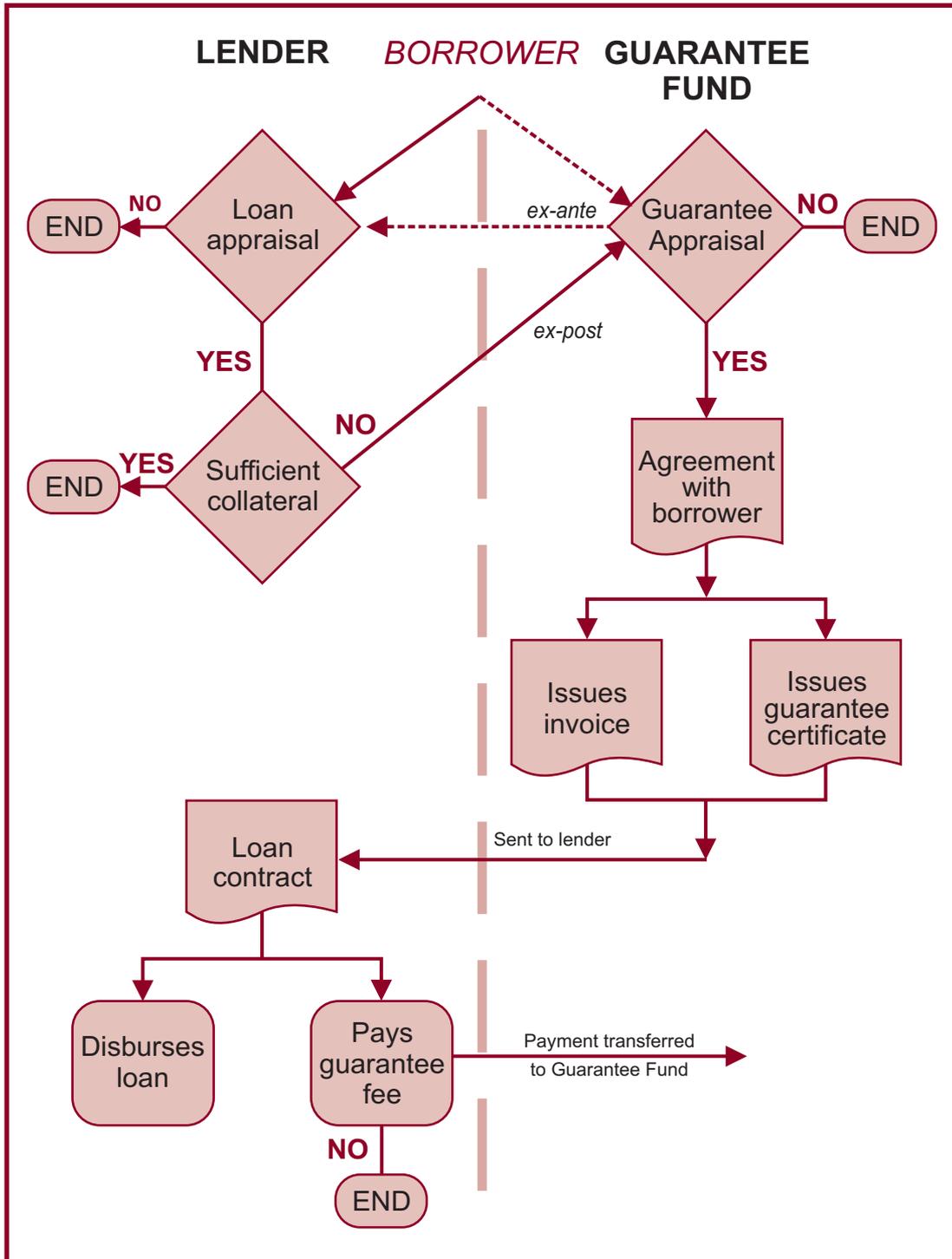
Normally applicants for a credit guarantee have to fill in an application form. The form will usually ask the entrepreneur to describe:

- the business activity
- the year of establishment
- legal status
- number of employees
- purpose of the loan
- amount of the loan and loan term
- required guarantee coverage
- available collateral
- assets owned
- debts
- income and expenditure.

In addition to the information on the application form, some credit guarantee funds require a business plan and/or certified financial statements.

We distinguished earlier between the *ex-ante scheme* where the entrepreneur first goes to the guarantee fund and then to the bank, and the *ex-post scheme* where the entrepreneur goes first to the bank and then to the guarantee scheme. In some ex-post schemes, the guarantee scheme uses the loan application documents without asking the borrower to fill in a separate application form.

**Figure 7.1 Flowchart individual guarantee scheme**



## 7.2 Appraisal procedures

In theory it is best if only the bank appraises the borrower, because bank staff are skilled in credit appraisal, and also because duplication is avoided and overall costs are reduced.

In practice, however, many credit guarantee schemes choose to appraise the borrower themselves, because:

- The partner bank may not have the skills to appraise small entrepreneurs.
- The partner bank may be reluctant to appraise small loan applications. Many banks do not have a specific department for small loans, and applications for such loans are dealt with by the same credit evaluation department that deals with large loans, but with the same costs.
- The partner bank may have a tendency towards adverse selection, only attaching credit guarantees to the most risky loans.

The more confident the guarantee fund is about the lender's appraisal procedures, the less time it needs to spend doing the appraisal itself. This is one of the many reasons why it is important for a fund to select reliable banking partners.

Ultimately the party that assumes the higher proportion of the credit risk ought to be more concerned with credit appraisal. In guarantee schemes that cover more than 70% of the risk, the guarantee fund has to devote a great deal of effort appraising borrowers and/or monitoring the bank's appraisal procedures.

In a portfolio guarantee scheme, there are lower operational costs, and the appraisal of the client is left to the discretion of the bank. Clearly a guarantee fund can only issue portfolio guarantees if it has full confidence in the appraisal techniques and goodwill of the bank.

## 7.3 Issuance of guarantees

In an individual guarantee scheme, a positive appraisal of the guarantee application will be followed by the issuance of a guarantee certificate. This certifies that the guarantee scheme will assume part of the credit risk of the borrower. The guarantee certificate stipulates the rights and duties of both the guarantee fund and the lender. (See Annex 1 for a list of clauses that commonly appear in a guarantee certificate).

*Good Practice:* Guarantee certificates might include clauses that are not easily understood by the clients. It is good practice for the staff of the guarantee fund

to verbally explain to the client the different conditions spelled out in the guarantee certificate. It will avoid later conflict if the client understands his or her rights and obligations before taking the guaranteed loan.

At the same time as the certificate is issued, the guarantee scheme will also issue an invoice for the guarantee fee. Guarantees schemes usually charge an annual fee of around 1% to 2% of the outstanding guaranteed loan amount (see Chapter 10 on pricing). In some guarantee schemes, the lender has to pay the fee to the guarantee scheme, and it is stipulated in the guarantee certificate that if this has not been done, the guarantee coverage is invalid. In other schemes, the borrower pays the fee. If the borrower pays, the guarantee scheme has to make sure that the fee for the entire loan term is paid in advance.

#### **Who pays the guarantee fee?**

There are two schools of thought with regards to the payment of the fee. One argues that the guarantee fund acts as a form of insurance for the lender. Therefore, as the lender is the ultimate beneficiary of the guarantee, he or she should pay for the guarantee.

The other point of view is that the borrower obtains access to formal lending through the guarantee fund. Therefore, according to this logic, the fee should be paid by the borrower.

In practice, the borrower pays the guarantee fee anyway, either by paying directly, or because lenders pass the guarantee costs on to borrowers by increasing the interest rate.

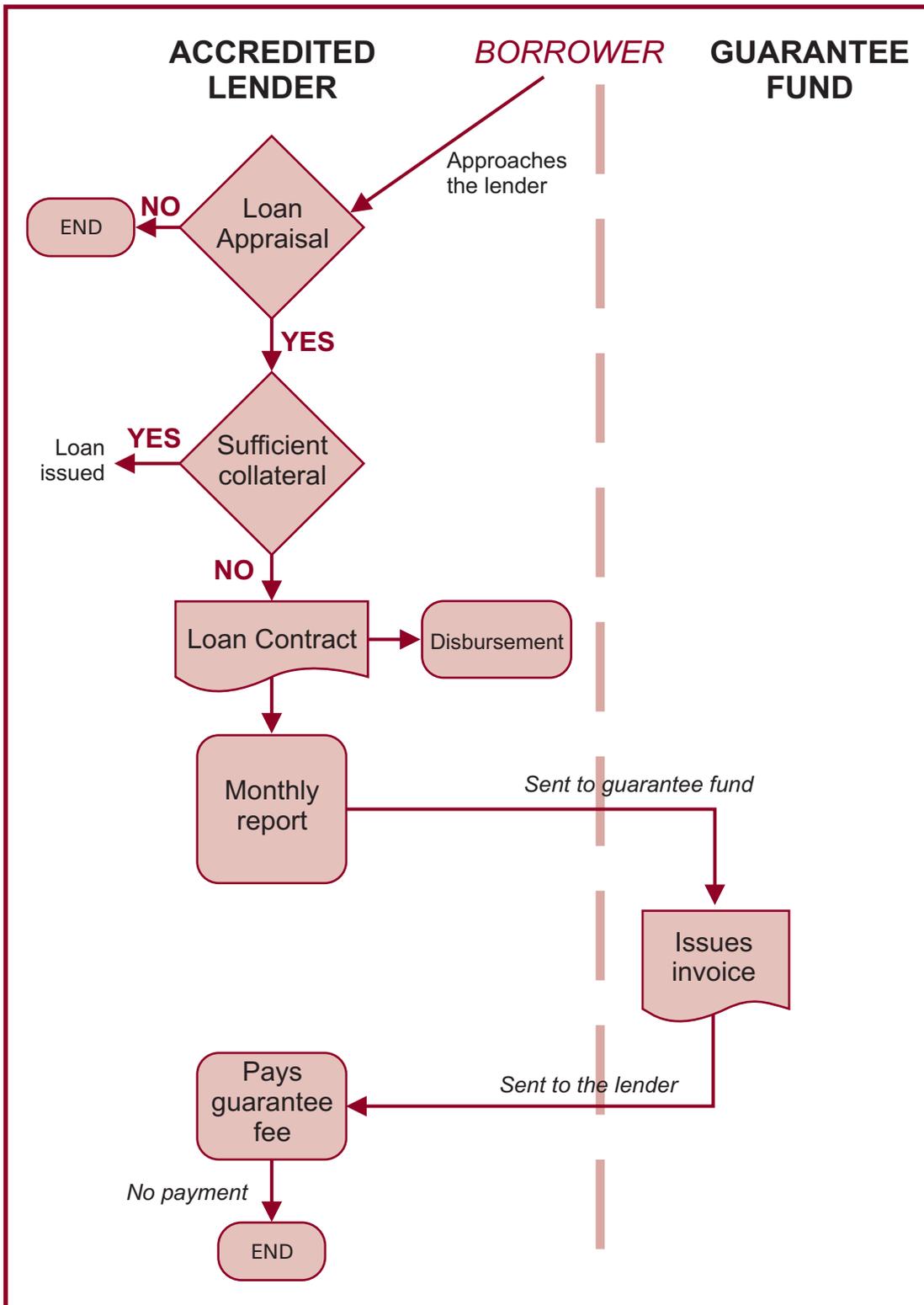
Once the guarantee certificate has been issued, the lender can issue the loan to the client.

In a portfolio guarantee scheme, the process of issuing guarantees is different. Here the guarantee fund provides a guarantee facility for the lender to extend loans to eligible borrowers. The terms of this facility are set out in a contract that defines the eligibility criteria and the roles and responsibilities of the bank and the guarantee fund. (See Annex 2 for a list of clauses that would normally appear in such a contract).

After signing the contract, the bank informs the guarantee scheme of all new loans included under the arrangement. Usually the bank will send information about the loan portfolio to the guarantee scheme on a monthly basis.

The bank pays guarantee fees over the entire guaranteed loan portfolio. If the fee is not paid for any one guarantee, that guarantee is automatically invalidated.

Figure 7.2 Flowchart portfolio guarantee scheme



## 7.4 Loan follow-up

The process of following up on loans is identical for individual and portfolio guarantee schemes, because repayment problems are always treated individually.

The bank sends information on the guaranteed loan portfolio to the guarantee scheme, typically on a monthly basis. Sometimes the guarantee scheme and the bank agree that the bank will report only if the borrower is in arrears. This arrangement has the advantage of reducing transaction costs for both parties.

If the bank fails to inform the guarantee fund of borrowers in arrears within the contractually stipulated time, the guarantee fund can invalidate the guarantee coverage. In general, it is sound practice to have a clause in the contract that compels the lender to provide monthly reports no later than fifteen days after the end of the month.

The monthly loan portfolio reports allow the guarantee scheme to follow up on any borrower in arrears. Follow-up can take the form of phone calls, visits and perhaps discussions on loan rescheduling. All follow-up contact must be documented and filed. All follow-up by the guarantee scheme obviously increases its operational costs.

Whether the guarantee scheme follows up on loans itself or leaves this to the bank, depends on the circumstances. In the ideal situation, the guarantee fund trusts the bank completely and leaves the bank to do the follow-up. In practice, though, the guarantee scheme is often involved in following up on arrears. This is especially the case in situations where a large percentage of the loan is guaranteed, so that the bank has little incentive to follow up on delinquencies.

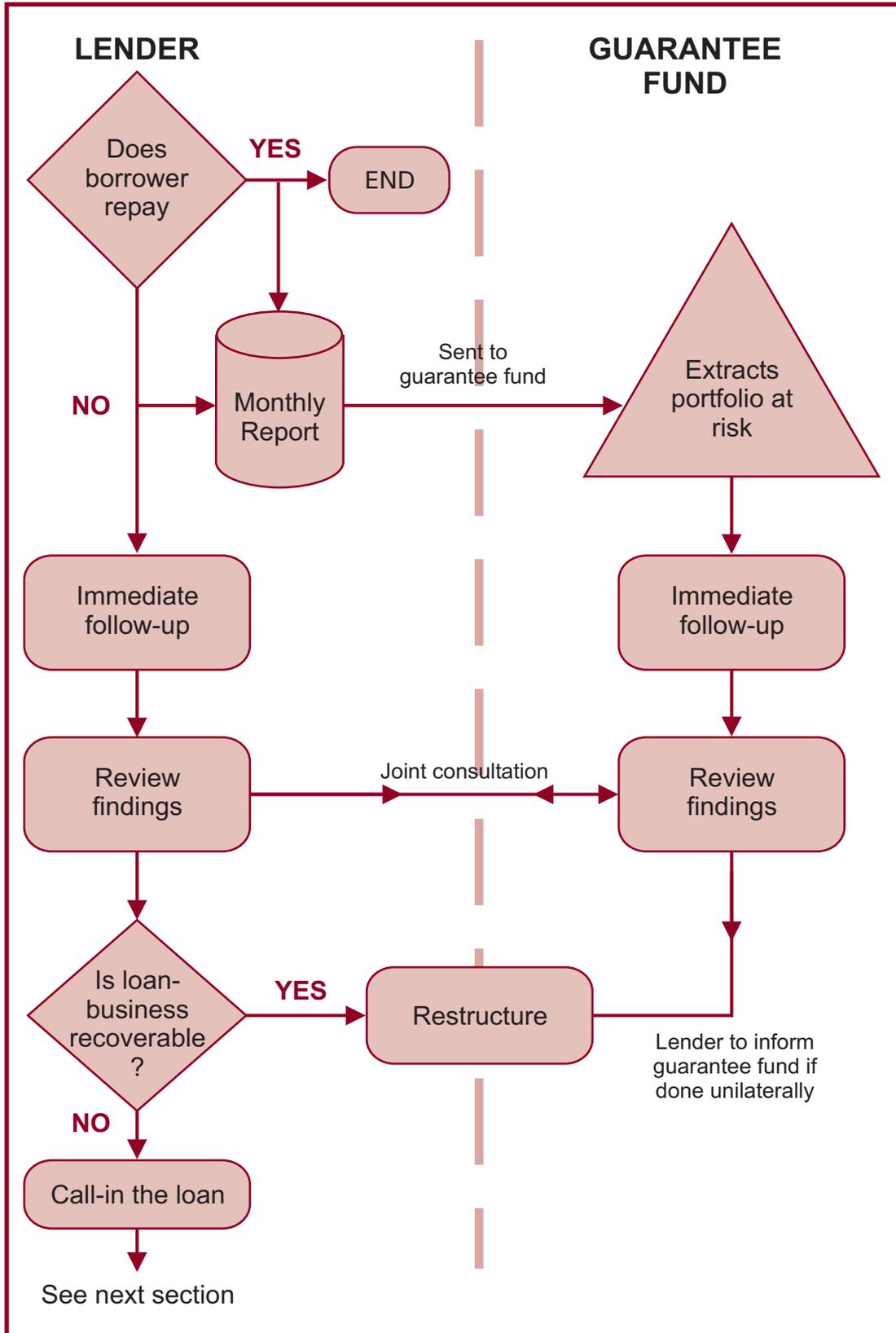
Loan follow-up should take place within two or three weeks of the first missed repayment. Once follow-up has been initiated, the bank and the guarantee fund have to review their findings and take action. Possible scenarios are:

- a) The borrower has merely failed to repay one instalment but is able and willing to repay this in the following month. In this case the loan is normalised after the payment of arrears and the guarantee continues.
- b) The borrower is willing to repay, but currently unable to. This may be a case for loan rescheduling.
- c) The borrower is either not willing or not able to repay.

Rescheduling is often done to encourage repayment, but it is risky and should only be done in extreme circumstances. Too much rescheduling may well harm the reputation of the guarantee scheme, because clients will think that the scheme is not all that strict on repayment.

Generally speaking, guarantee schemes should not allow banks to decide unilaterally on loan rescheduling. If a bank reschedules loans of borrowers who are unwilling or unable to repay, the bank increases the liability of the guarantee scheme. Only in circumstances where the guarantee scheme has full confidence in the judgment and the goodwill of the bank, should the bank be allowed make these decisions unilaterally.

**Figure 7.3 Flowchart loan follow-up**



## 7.5 Claims

The conditions under which a bank can call upon the guarantee scheme to pay out will be stated either in the contract between the bank and the guarantee scheme or in the guarantee certificates. Usually the bank can call in claims after:

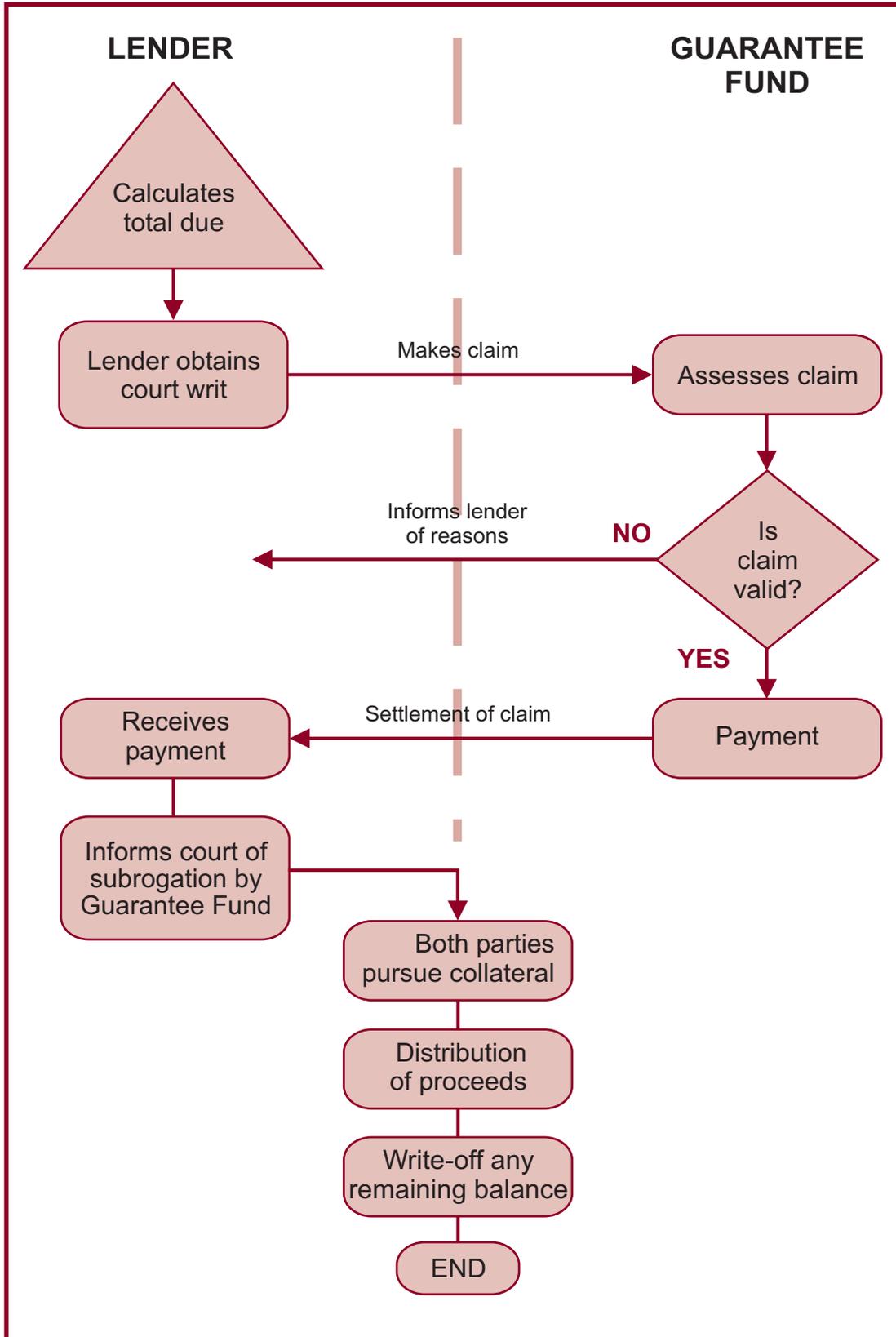
- Arrears have reached 90 days
- Borrowers have been appropriately warned
- The outstanding loan has been called in
- Legal proceedings have been initiated to foreclose on collateral and recover the debt.

Before the bank can send a claim to the guarantee scheme, it must apply to the court for a writ. The writ will demand that the borrower must settle the claim or defend the writ in court. The bank can then send a claim to the guarantee scheme, attaching a copy of the writ. The writ acts as proof that the bank has initiated legal procedures.

Normally the guarantee is called in after a fixed number of days following the first missed instalment. This usually coincides with the bank calling in the outstanding loan amount. The most common time period is 90 or 120 days.

*Good practice:* Avoid clauses that give the guarantee scheme opportunities for not paying the lender. Clauses such as ... “the lender will diligently attempt to recover from the borrower” are vague and create scope for conflict between the bank and the guarantee scheme. Also avoid clauses that are unattractive to the bank such as ... “the guarantee scheme will only pay at the end of all legal proceedings”. In some countries legal proceedings may go on for years.

**Figure 7.4 Flowchart legal action**



## **7.6 Validation of claims**

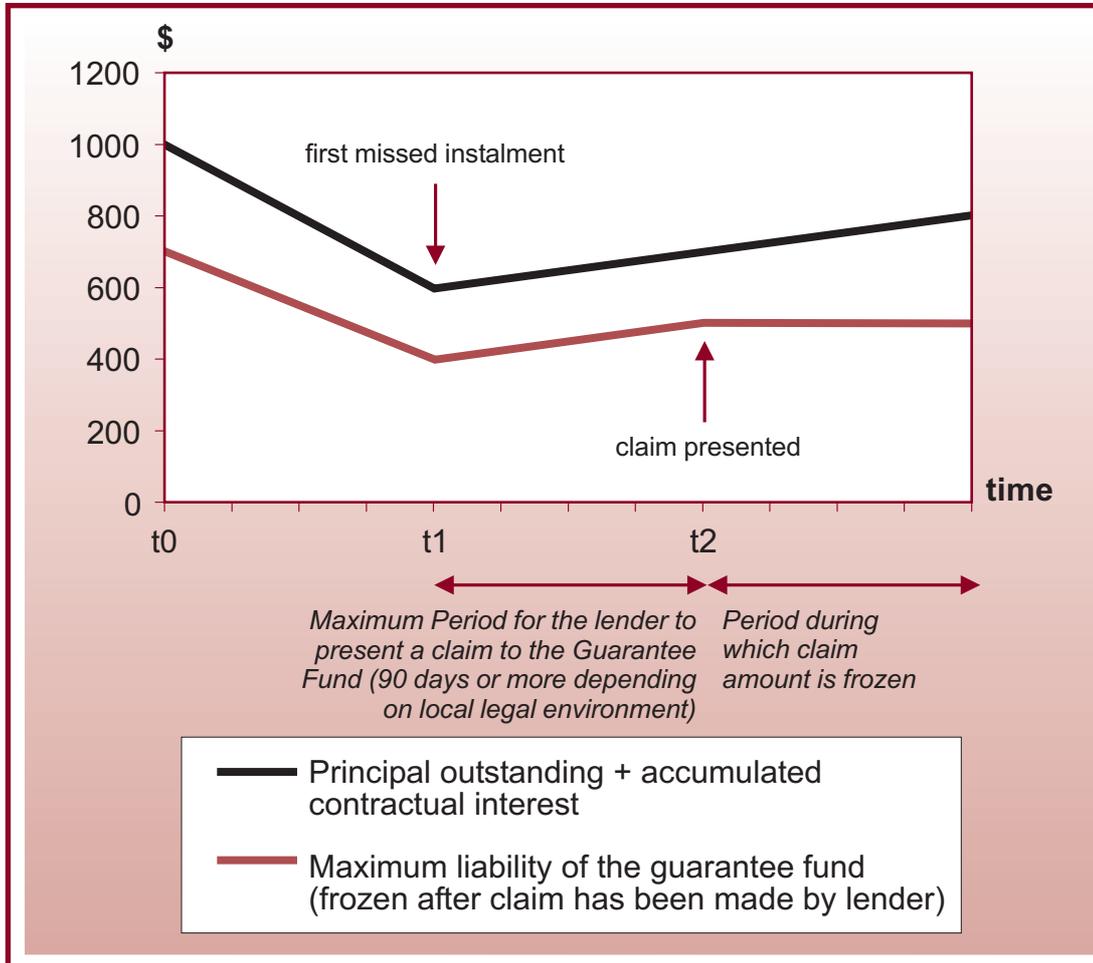
On receiving a claim, the guarantee scheme has to assess its validity. The guarantee scheme should immediately ascertain that:

- The fee was paid by the lender for the relevant period
- The claim was presented to court within the agreed timeframe
- The bank had not rescheduled the loan without the approval of the guarantee scheme
- The borrower was eligible for the guaranteed loan and the loan was not disbursed prior to the signing of the guarantee contract.

The guarantee scheme then has to assess the correct amount of the claim. The claim should not include any cost elements over and above what is stated in the contract or certificate. Guarantee schemes do not normally cover any penalty interest or legal fees incurred by the bank.

The guarantee scheme should then verify that the interest component of the claim has been calculated according to the guarantee certificate or contract. The claim should only include unpaid interest up to a certain number of days after the first missed instalment. The bank cannot be allowed to put in its claim a year late and then claim 12 months of non-paid interest from the guarantee scheme. Figure 7.5 illustrates this point.

**Figure 7.5 Maximum period for the lender to present a claim**



If the claim is invalid, the bank must be informed immediately that the guarantee scheme refuses to pay, and why. If the bank gets the impression that the guarantee scheme is stalling in its payment of guarantees, it might lose confidence in the scheme. Cumbersome pay-out procedures have led to the failure of many guarantee schemes.

## 7.7 Payment of claims

Once a claim has been validated, the guarantee scheme has to pay within the stipulated period. Often the bank will already have funds deposited in the guarantee fund's name, by prior arrangement. It is important that the bank is not given a blanket authorisation to debit the guarantee fund's account, because it may be appropriating funds before the guarantee scheme has

approved the payment. Where the guarantee scheme has such deposits, there should be an agreement in place to specifically authorise the bank before its deposit account is debited.

It is best if there is a time limit on the period by which the guarantee fund has to pay the lender, for example 30 days from the day the claim is presented to the guarantee fund. This gives the guarantee fund time to ensure that all conditions have been met and inform the lender of its decision. There is sometimes a case for paying out a guarantee despite minor technicalities, as long as the guarantee fund manager believes that the bank has acted in good faith.

Speedy payment is one of the most important ways for a guarantee scheme to preserve an excellent relationship with its partner bank. Payment can take various forms:

- Single payment once the claim is presented and validated.
- Advance payment of a fixed percentage once the claim is presented and validated, followed by the balance once legal procedures have been exhausted.
- Single payment once legal procedures have been exhausted (this option is not advisable however).

The form of payment should be stated in the guarantee contract or certificate. If the legal system functions well, the guarantee scheme may consider an initial payment of a certain percentage and wait until all legal procedures have been exhausted before making the final payment. In this way the lender has an incentive to follow up on legal procedures closely. This option is also healthy for the fund's cash flow. However, in countries where the legal system functions slowly or defectively, banks will not be willing to agree on a staggered payment.

**Table 7.1**  
**Forms of payment**

Single payment – advantages	Staggered payment – advantages
More attractive for the bank	The bank has more incentive to recover from the client
Lowest administrative cost for the guarantee fund	Improves cash flow for the guarantee fund
Easy to understand	

## 7.8 Recovery of losses

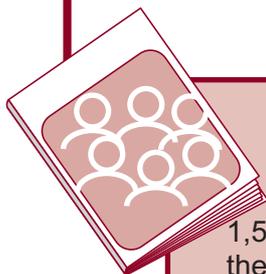
A guarantee scheme that has paid out a claim to a lender will normally have some rights to the collateral pledged by the borrower. If the guarantee fund provided a 100% guarantee, it will have the right to claim all the collateral. If the guarantee covered less than 100% of the loan, collateral proceeds are distributed between the lender and the guarantee fund. A 70% risk coverage, for example, will normally result in the guarantee fund receiving 70% of the proceeds from the sale of collateral. A 50/50 agreement, which is common in portfolio guarantee schemes, will result in a 50/50 distribution of proceeds.

In some countries, the law states that guarantors automatically have the right to recover losses from borrowers. Even if this right has been defined by law, it is important that it is re-stated in the guarantee contract between the bank and the guarantee scheme.

Judicial procedures for seizure of collateral are costly and time-consuming, and banks are reluctant to follow up on judicial procedures if the value of the collateral is low. They will be even more reluctant if a large part of the collateral proceeds go to the guarantee scheme. At the same time, many guarantee schemes do not have the staff capacity to follow up on judicial procedures. In practice, the party that has most to gain is likely to put the most effort into seizing collateral. Guarantee schemes should define a clear strategy for seizure of collateral based on a realistic perception of the practicability and time-scale of judicial procedures.

In some funds there is an agreement with the participating bank that it will transfer any claims it has on the borrower, but only after the guarantee fund has paid out the guarantee. Many banks prefer this route as they do not want to lose time, energy and public image on physically seizing and selling assets. They would rather see the guarantee fund doing so and accept that they might lose some money. In such cases, the guarantee fund can add the value of collateral seized to their balance sheet as assets. Later, when the assets are liquidated, the corresponding corrections can be made if proceeds differ from the recorded value.

## Case Study: Sharing of collateral proceeds



Consider the following scenario. A borrower defaults, leaving an outstanding amount of € 8, 000 due. The borrower has provided € 1,500 of collateral. A guarantee fund has a risk-sharing arrangement with the bank in which the guarantee fund covers 70% of the risk.

How do the bank and the guarantee fund share the proceeds? There are two ways this can be done.

**Possibility 1:** *In accordance with the pre-determined line of risk, the bank calls the borrower first and then the guarantee fund. Under this arrangement, as a first step, the bank undertakes legal actions against the borrower for the seizure of the collateral pledged in its favour. The proceeds of the legal action may be delayed due to the legal environment, so in practice claims are presented to the guarantee fund as soon as legal action is instituted rather than after proceeds have been collected.*

The bank makes a claim against the guarantee fund for the amount it agreed to cover (70% of € 8,000 = € 5,600). At that time, with no proceeds received, the guarantee fund will have to pay € 5,600 to the bank. When the bank receives the proceeds from the legal action undertaken against the defaulting borrower (€ 1,500) it will treat this *pari passu* and will transfer to the guarantee fund an amount of 70% of € 1,500 = € 1,050.

The losses that the bank has to absorb are 30% of the net losses after recovery i.e.

$$€ 8,000 - (€ 5,600 + € 450) = € 1,950$$

(The €5,600 comes from the guarantee fund and the €450 from the borrower's collateral).

The net result for the guarantee fund is that it incurs 70% of the net losses after recovery i.e.

$$€ 5,600 - € 1,050 = € 4,550$$

(€ 5,600 is the amount it paid to the bank and € 1.050 was recovered from the borrower's collateral).

Under this scheme, the risk was shared between the guarantee fund and the bank in accordance with the percentages stated in the guarantee contract.

**Possibility 2:** *Under this arrangement the proceedings are not split *pari passu*. In this scenario, the bank retains (from the proceeds of collateral) the balance of the debt that was not paid by the guarantee fund. Any remaining proceeds go to the guarantee fund.*

In this case, the guarantee fund will pay the bank € 5,600; furthermore, the bank will receive the proceeds from its legal actions against the defaulting borrower (€ 1,500). The bank will thus record a loss of only € 900 i.e. € 8,000 – (€ 5,600+ € 1,500). The guarantee fund, on the other hand, will show a net loss of € 5,600, as no proceeds remained.

**Workshop Exercise:**

Look at flowcharts 7.1, 7.2, 7.3 and 7.4. Are the processes and procedures in your guarantee fund similar to the ones depicted in these flowcharts? If not, make your own flowchart describing the procedures for application, appraisal, issuance of guarantees, loan follow-up, claims and payment of claims in your guarantee fund. Present the results to the other participants.



# RELATIONSHIP MANAGEMENT AND MARKETING

## *This chapter:*

- *gives suggestions for establishing and maintaining good working relationships with partner banks*
- *presents the opportunities and pitfalls of working with different types of funding partners*
- *outlines the components of an effective communication strategy with clients and potential clients.*

## 8.1 Relationship management with core stakeholders

In order to function properly, a guarantee fund must maintain good contacts with its core stakeholders: the banks, the financiers, and the small entrepreneurs. For each of these groups, a clear communication strategy is needed.

## 8.2 Establishing relationships with partner banks

Not all lenders are interested in providing small loans. Guarantee funds often waste time and resources trying to convince lenders who are not interested and not likely to become interested. It is not necessary to convince all banks and financial institutions to collaborate with the guarantee fund. But it is useful for the guarantee fund to map the lenders operating in its targeted geographical area. This helps the management of the fund to understand the positioning of the various lenders and their possible roles in financing small enterprises.

The fund should draw up a list of criteria that lenders would have to comply with in order to be eligible for participation in the guarantee programme. Such a list would include these criteria:

- The image of the lending institution
- Its market position
- Its relations with the small enterprise sector
- Composition of its portfolio
- Quality in lending (procedures and overall performance of portfolio)
- Staff capacity
- Innovative character
- Financial strength

Some of this data can be obtained either from the central regulatory authorities or from annual reports of banks. More qualitative information can be gathered through informal discussions within the sector.

After data collection, consultations with different lenders are needed. In these discussions the prime objective is to assess whether bank managers are interested in collaborating with the guarantee fund.

After their first contact with the guarantee fund, lenders will ask for detailed information. It is good practice to have information packs prepared in advance for distribution to senior bank officials. These should include:

- A description of the guarantee fund, including its mission statement
- A description of the owners and funding partners of the guarantee fund
- The financial statements
- The fund's eligibility criteria
- A description of the main procedures for issuing guarantees, reporting, claims handling, pay-outs, recovery procedures and division of proceeds from collateral

In your consultations with lenders, stress why improved financing of small enterprises would be of interest to the bank. You can mention these advantages:

- A lot of small enterprises will grow into larger ones, and the bank will benefit from this growth.
- A guarantee fund will help the bank to expand its client base with little additional risk.

- Once the enterprises are clients of the bank, they are likely to use the bank's other financial services.
- The bank will benefit from lower risk provisions, assuming that the guarantee provided by the fund has been assessed as "acceptable collateral" by the national supervisory body.

Emphasise that only reliable entrepreneurs with sound business plans will be referred to the lender by the guarantee fund, and that this should also apply to those referred to the guarantee fund by the lender. Mention that the guarantee facility will be withdrawn if the lender misuses it by including abnormal numbers of dubious clients.

After the initial consultation, the lender will assess the desirability of establishing a working relationship with the guarantee fund. It is important to have a sense of how the lender will want to do this, so that the guarantee fund can prepare for any questions the lender may raise. In most countries the banking laws will include relevant regulations on collateral. Lenders will want to look at the guarantee fund in the context of these regulations.

If the bank decides that it wants to establish a working relationship, the next step is to draw up a draft of the contract and the guarantee certificate. Several people within the bank will review the draft. In the case of *portfolio guarantees*, this is a long process involving lawyers, credit officers, the operations and data processing departments. This may take between four to eight weeks. While this is happening, the guarantee fund should monitor progress and be ready to respond to any questions.

The contract between the guarantee fund and the bank can only be finalised once the roles have been defined adequately and have been accepted by both parties. It is often good publicity to sign the agreement at a ceremony to which the business community, the local authority and the media are invited. This will be an opportunity for the bank to advertise its social awareness through its assistance to the community at large.

### 8.3 Training of branch managers and operational staff

All the above introductory discussions and signing of the agreement will have been conducted between the head offices of the bank and the guarantee fund. The next step is for the lender's branch managers to be informed of the agreement, and to be trained on how to work with the guarantee fund. Without

the active involvement of branch managers and operational staff, few guarantees will be requested.

In principle, the lending institution should train its own branch managers, but in practice this rarely happens. It is advisable that the guarantee fund offers training sessions to bank officials. These should include:

- General principles of small enterprise lending
- The benefits of the guarantee fund to the branch manager
- A description of how to use the guarantee facility and how the facility fits into the overall procedures of the bank

Banks and their staff often argue that they face restrictions in lending to small enterprises because their own internal regulations define such loans as high risk. This is usually due to the fact that small businesses cannot provide reliable information. The training must pay attention to this and indicate how a guarantee fund can help to solve these problems.

A hindering factor in lending to small enterprises, and one which banks themselves often overlook, is the behaviour of their own staff. Banks are traditionally hierarchical organisations, and operational staff do not like to jeopardise their chances for promotion, which is determined, at least in part, by their performance expressed as return on capital invested. For them, losses incurred always have to be within ranges that can be controlled, i.e. ranges that can be recovered. Individual staff members operate in such a way that the potential losses on their portfolio remain within such limits, otherwise they put their careers at risk. Guarantee funds should understand that the losses incurred per client and per portfolio should be within the limits that banks will allow their staff.

Bank transparency rules call for clear segregation of responsibilities with regard to financial decision-making. In approving or rejecting a loan application, banks take two types of decisions:

- appraising whether the entrepreneur will generate enough profit to pay interest and repay the principal. This is a process that requires insight into entrepreneurial behaviour and the economic performance of the particular project to be financed.
- appraising the gap in collateral that can be pledged (and can be recovered) and the corresponding risk exposure for the banks.

Good banking and financing requires segregation of these two types of decisions and having separate criteria for each of them. It is necessary to have clarity on these issues and clearly define where the guarantee fund fits in. The guarantee fund can provide supplementary guarantees to bridge the collateral gap.

Guarantee funds should not try to duplicate the evaluation process that the banks carry out. If the guarantee fund and the banks define properly each other's role and each stick to their core business, duplication in decision-making processes will be avoided.

## 8.4 Monitoring the performance of partner banks

Guarantee funds need to constantly monitor the performance of participating banks and act swiftly when they see that performance is deteriorating. If banks perceive the guarantee fund as an insurance company they might be tempted to refer weaker (poorer performing) clients to the fund. Risks can then suddenly increase steeply.

The guarantee fund needs to stipulate in its contract with the lender that should its "portfolio at risk" (see Chapter 11) exceed the agreed limits, the guarantee fund will stop issuing new guarantees to that lender. In some cases, fees might be increased or the coverage reduced.

The guarantee fund must not be afraid to be critical, and it can do this while acting professionally. It helps to have a clear policy that stipulates what steps will be taken to retain or exclude lenders as partners.

*Good practice:* The sooner the guarantee fund responds to a deteriorating portfolio, the better. In fact if a guarantee fund stops issuing guarantees to a lender who is making poor loans, the confidence of other participating lenders will be improved.

*Good practice:* A guarantee fund should work with a number of lenders. In doing so, it spreads the risk. Increased competition amongst lenders will also enhance lender performance. However in its start-up phase, a guarantee fund should not aim for too many participating banks. This is because much time and energy has to be invested to get banks involved. Explaining procedures and motivating bank staff to make use of the guarantee scheme all takes time.

## **8.5 Relationships with financiers**

Guarantee funds are often created for macro-economic and development purposes, with the understanding that promoting small business boosts local economies and creates employment opportunities. The first funding of guarantee funds often comes from public entities, donor agencies, development finance agencies and NGOs.

Those who found a guarantee fund must be aware of the conditions that these first financing entities are likely to attach to their involvement. What is their demand for returns on investments? What is their capacity and willingness to provide additional funding when needed? One should not underestimate the effect of the conditions that donors put on their funds – these conditions may well limit future financial decisions of the guarantee fund's management.

It is also important to have clarity about who actually owns the funds made available by donors. The official and legal transfer of these funds is usually subject to many conditions and bureaucratic procedures. For example, can the guarantee fund use the funds as its own equity, or should it rather treat the contributions as interest-free loans?

To clarify these issues, the contract with the funding party should include the following:

- The purpose of the financing
- The ownership of the funds
- Possibilities for additional funding
- The role of the financing party in the governance of the fund
- Any supporting services that the funding party will provide
- The reporting requirements

Larger donors and financing bodies can affect the image and perception of the guarantee fund in the market. A common problem happens when a government sets up and provides the core financing of a guarantee fund, and then promotes the guarantee fund as its own initiative, sometimes with a political dimension. Then the perception of entrepreneurs will be that the guarantee fund is a government sponsored entity, and this will most likely have a negative impact on repayment rates.

In the very short term, a new guarantee fund cannot expect a return on investment. Risks are still high, the volume of operations is low, and a position in the market has yet to be gained. Only after a number of years will the guarantee fund show the results and track records that will attract other

financing parties. It is important that the fund management will by then be operating freely, detached from the original funding parties. The image of the fund will need to be in line with the expectations of the new financiers.

*Good practice:* Even at the early stages, a guarantee fund should formulate the ideal financial mix that it wishes to achieve, and launch its publicity and marketing strategy accordingly. If a guarantee fund, for example, wants to attract contributions from Chambers of Commerce or business associations, a long term strategy in this direction is needed.

## 8.6 Marketing the guarantee fund to small enterprises

Marketing itself to potential users is one of the most difficult challenges that a guarantee fund has to face. The messages sent out, in all their forms, define the image of the fund. The way small entrepreneurs receive and perceive these messages will form their expectations of how to approach the fund and deal with its conditions. A well thought out communications strategy is therefore essential.

Messages are sent out in a variety of forms:

- Brochures and leaflets
- Advertisements and announcements
- Presentations at trade fairs and events
- Verbal messages and explanations
- Official documents
- Word of mouth amongst the client group

The guarantee fund must ensure that there is uniformity and consistency in all forms of messages sent out. The technical staff of the guarantee fund plays a key role here, since they are the ones (except for portfolio schemes) who have direct contact with the clients. The small entrepreneur usually wants and needs the guarantees and, because of that dependency relationship, he or she will tend to accept all that is explained by the staff as the truth.

Good starting points for general marketing are contacting business associations, attending trade fairs and placing advertisements in the local media. Care should be taken to identify reliable business associations and establish solid contacts with their leaders and responsible officials. Remember

that these officials will be explaining to their members what they have learnt about the guarantee fund.

The next level of marketing is more directed to the prospective individual user, the small entrepreneur. This requires a message with more precise information, like conditions and requirements. A good way to do this, which also reduces costs, is to organise group sessions to explain to entrepreneurs the services provided. At such seminars you can present the benefits of a guarantee, introduce the guarantee fund, and explain its eligibility criteria as well as the lender's policies and procedures.

*Good practice:* Be sure that your explanations are easy to understand. They should be in plain language, with examples and typical case studies. Discuss fee structures openly. Stress the importance of the borrower establishing a sound credit history with the lender, and how this will lead to access to future loans.

*Good practice:* Honour your promises! As part of your ongoing marketing effort, it is essential that your fund is known as an institution that can be trusted. If the guarantee fund takes too much time appraising applications, for example, or later adds requirements not previously mentioned, it rapidly loses credibility with both lenders and borrowers.

A third (often overlooked) stage in marketing comes after the guarantees have been extended. At this stage you can promote success stories. These add to the image of the fund and can be helpful in illustrating how guarantees can be used. Publicity about failures can be equally important. Public information about cases where the fund has repossessed assets demonstrates to the general public and the small enterprise sector that the fund is a professional entity which abides by its policies.

### **8.7 Moral hazard: the risk of misperceptions**

Incorrect understanding of the guarantee scheme creates problems of moral hazard. The most common kind of moral hazard happens when clients perceive the guarantee fund as a kind of insurance company which will pay out to the bank if they cannot repay their loans. This problem is more likely to arise after a number of years, rather than at the launch of the fund. So right from the beginning it should be countered by a very clear communication strategy.

A second problem, sometimes related to the first, is when clients consider the fund as a developmental or social organisation. This can arise because the guarantee scheme's funding may be coming from developmental or social

organisations. These funding partners may insist that their names are mentioned as supporters of the fund. But what is the added value of this message? It easily encourages an attitude amongst clients of “well, it is a development programme after all, so why should we pay?”

Finally, it is very important to make eligibility criteria known to the general public and the potential target group. Clear eligibility criteria will mean self-selection by clients, which in turn will reduce the workload of the staff of both bank and guarantee fund, who have to provide information to potential clients and screen applications. Making the eligibility criteria known to the general public will also reduce pressure on the guarantee fund from people who see it as their civil right to be granted a guarantee.

### **Workshop Exercise:**



In small groups, try to find answers to the following questions about a guarantee scheme that you are familiar with:

- What are the main contentious issues between the guarantee scheme and the partner bank(s)?
- What are the underlying causes for these issues?
- What can the guarantee scheme do to improve the relationship with the partner bank(s) regarding these contentious issues?



## ORGANISATION, MANAGEMENT AND STAFFING

### *This chapter:*

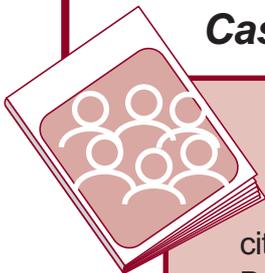
- *stresses the need for a clear mission and vision statement and clear operational objectives*
- *discusses the composition and the tasks of the Board of Directors*
- *describes the different staff functions needed by a guarantee fund.*

### 9.1 Mission, vision and objectives

A guarantee fund exists to bring about certain changes in society. This purpose must be laid down in a mission statement. The mission statement has to be formulated clearly and taken seriously, because it defines funding prospects and sustainability of the fund. Future assessments of the performance of the fund will be related to the mission statement.

The mission statement will help the guarantee fund make its purpose and objectives clear to partner banks and potential financiers. It is the foundation of the fund's communication strategy with clients. It should be agreed upon by the stakeholders and known by everyone who works in the organisation.

#### **Case study: mission statement of a guarantee scheme**



The mission statement of the Brownfield Area Loan Guarantee Program in Florida, USA is: "To enhance economic activity in the cities and counties of the State of Florida by redevelopment of the Brownfield Area. This can be accomplished by promoting financing for projects related to redevelopment of the Brownfield Area, through the Brownfield Area Loan Guarantee Program, which will ultimately increase the purchasing power and opportunities for gainful employment of citizens of the cities and counties of this state".

Once the mission statement is clear, the fund can determine its principles and priorities. This is where the stakeholders and, in particular, the governing board and staff, have to formulate a vision. Their vision will be the basis for the strategy of the organisation. The vision will focus on the type of small enterprises to be reached, the size of the guarantee fund, its position within the financial landscape, and the overall turnover and funding it aims to achieve.

After the mission and vision statements, clear operational objectives have to be formulated. Setting these objectives obliges the staff and board of the guarantee fund to be specific about a number of key issues, namely:

- The numbers of small entrepreneurs to be reached
- The expected volume of guarantees
- The required quality of the portfolio
- The number of participating banks
- The size of the guarantee fund
- The income from fees and investments

If the objectives are to serve as appropriate guiding principles, they have to be formulated in a very specific manner which will allow management, board, staff and other stakeholders to later measure whether they have been attained.

## 9.2 Organisational culture

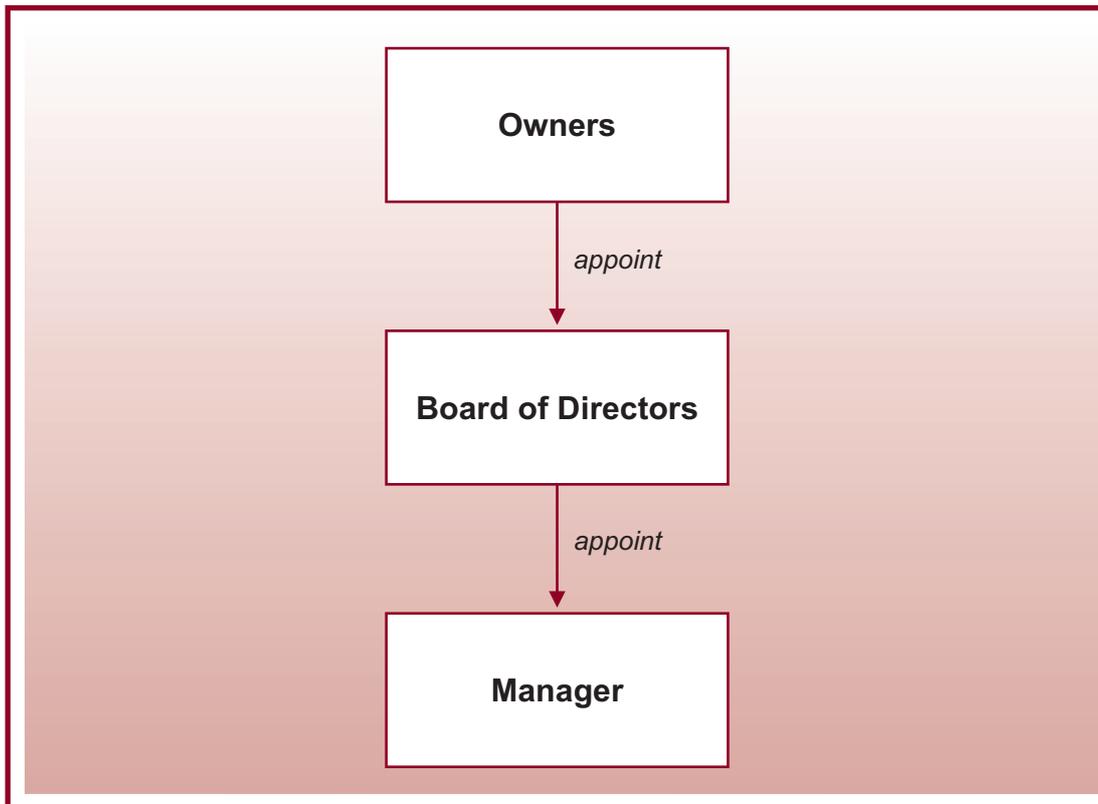
Staff and management of the guarantee fund must be conscious of its organisational culture. All staff must know the purpose of their work and the reasons why the guarantee fund exists. Their entire performance and attitude must reflect the mission and vision of the guarantee fund. This will ultimately determine uniformity in decisionmaking on guarantee applications, uniformity in the selection of participating banks, and uniformity in communication with potential clients.

The organisational culture also has a direct effect on the way the guarantee fund presents itself to the outside world. It will show in the guarantee fund's professional image and project a clear message of both the possibilities and the limitations of the guarantee fund. Internal seminars, workshops and working meetings all can have a positive impact on organisational culture.

### 9.3 Governance issues

In most commercial organisations, the owners choose a board of directors who in turn appoint the manager, as shown in the diagram below.

**Figure 9.1 The appointment of the board of directors and the manager**



A guarantee fund's board of directors can include investors, donors, government departments, lenders or lenders' associations, and small entrepreneurs or small entrepreneurs' associations. In general, it is advisable for all stakeholders to feel a certain degree of ownership of the scheme. Thus the fund should strive to include on its board representatives of the different stakeholder groups, and try to balance the interests of the different parties.

In selecting board members, care should be taken that certain expert qualities are represented as well, in particular:

- Expertise in SME lending
- Strategic experience

- Accounting and legal expertise
- Political expertise
- Relationship with financiers

While all stakeholder viewpoints should be represented, it is advisable not to have any single stakeholder group over-represented on the board. Most funding parties, for example, like to have a seat on the board, but it should be explained to funders that their representation as a group should not overwhelm the interests of other groups. Decisionmaking power within the board must be clearly spelled out, preferably de-linking this power from the volume of funding. Decisionmaking rules should be clear for all.

A manageable size for the board is between five and seven members. There should be a minimum number needed for a quorum; for example, for a board of seven members, at least four would be required to pass a decision. If consensus cannot be reached, the issue should be voted upon using a simple majority. A board need not meet more than three to four times per annum.

Often the needs of board members will conflict. For example, a donor may want to reduce its subsidy to the fund and suggest that the fund increases its fees. A representative of small business, on the other hand, may want the fund to reduce its fees to get cheaper guarantees.

There are two ways to help avoid such conflicts:

- Have unambiguous mission and vision statements and clear organisational objectives. The more unequivocal the goals and objectives, the less room there is for conflict to emerge.
- Ensure that, well before board meetings, all members of the board are provided with clear reports in a standard format. While this may mean more work for management, in the long term this practice will enhance the sustainability of the guarantee scheme.

In all guarantee funds, irrespective of size, it is crucial to separate the functions of the board of directors from that of management. The board's role is to focus on policy issues, strategy and overall development of the guarantee scheme within the financial landscape. It should set out the standards for risk exposure, define the desired financial structure of the fund, and define profit targets and profit distribution. The board appoints the managing director and has the authority to fire him/her, but the board cannot and should not manage the fund. That is the responsibility of the managing director.

## 9.4 Professional staff functions and positions

The key staff members of a guarantee fund are the professionals who handle and appraise applications and guide the small entrepreneurs. The number and quality of such people and the effectiveness of their services make up the capacity of the fund.

The challenge for management is to keep fixed costs as low as possible and thus keep the numbers of staff to the absolute minimum. Management therefore has to make a clear distinction between functions to be carried out and personnel recruited. Some functions can be combined in one and the same person, but others cannot. And even if a function cannot be combined with others, it is not a prerequisite that all personnel are recruited on a fulltime basis.

The basic *operational functions* performed by a guarantee fund are:

- Appraisal of applications
- Monitoring of the portfolio
- Claims handling

The basic *supporting functions* performed by a guarantee fund are:

- Budgeting and planning
- Administration
- Accounting

The additional functions that a guarantee fund can take up, or can subcontract, are:

- Marketing
- Fundraising
- Research
- Auditing (external)
- Recovery of assets

A clear distinction must also be made between the tasks and responsibilities of the lenders and those of the guarantee fund. The degree of confidence between these two institutions will determine to what extent there will be overlaps – the more confidence, the less overlaps are necessary.

## 9.5 Staff capacity and training

Guarantee funds normally recruit some of their core staff from the banking sector and from enterprise development organisations. These staff members can be expected to have a basic knowledge of small enterprise financing and appraisal techniques. In selected areas they might need additional in-house or external training.

Other staff members are recruited at the job market. Selecting them requires a careful assessment of their basic knowledge of the tasks they will need to carry out. In-house guidance and on-the-job training and advice and coaching are often sufficient. In certain cases, additional training might be considered.

Internal training must be organised at regular intervals to create a specific organisational culture and attitude within the guarantee fund.

**Table 9.1**  
**Staff functions and skills required**

Selected core functions	Key activities	Skills required	Training
Appraisal	Appraising guarantee applications	Business appraisal skills	External and in-house training
Monitoring	Monitoring banks performance Monitoring clients	MIS (Management information systems) skills Communication skills Business appraisal skills	External training and in-house instructions
Claims handling	Validation Approval of payments Disbursement	Legal skill Accounting skills	External training

Selected core functions	Key activities	Skills required	Training
Recovery	Debt collection Legal action Subrogation Sales of assets	Legal skills Accounting skills	External training In-house instructions
Budgeting and planning	Financial planning Budgeting	Financial skills Accounting skills Computer skills	External and in-house training
Administration	Filing Secretariat	Computer skills	External training
Accounting	Financial administration	Accounting skills Computer skills	External training



## PRICING AND FINANCIAL SUSTAINABILITY

### *This chapter:*

- *identifies the different cost elements and sources of income of a guarantee fund*
- *presents a method for setting fees on a cost basis*
- *discusses whether guarantee funds should strive to be financially sustainable*
- *introduces avenues to improve financial sustainability*

### **10.1 Cost recovery**

In order to ensure its continuity, the guarantee fund must cover its costs, which are:

- Cost of funds
- Losses on guarantee operations
- Operational costs

The sources of income, which should be sufficient to cover costs, are:

- Guarantee fees
- Administrative fees
- Income from investment

### **10.2 Cost of funds**

In most cases, the funds used for a guarantee scheme are financed through equity contributions. Although no dividend or interest is paid on these contributions, their cost is not zero. Because the fund will not want the value of the equity contributions to decrease over time, it has to keep up with the

inflation rate. This means that, for the part of the guarantee fund that is financed with equity, the cost of funds will equal the inflation rate.

Some guarantee funds borrow on the capital market in order to cover the guarantees that they issue. If a guarantee fund borrows money in this way, its costs will be higher, and this has to be reflected in the pricing of the guarantees.

Sometimes, guarantee funds are composed of a mix of equity and debt. Not all loans are obtained under the same conditions, so it is necessary to apply the weighted average cost of capital method to arrive at a reliable estimate of the costs of funds.

In summary, the cost of funds for a guarantee fund is thus determined by:

- The inflation rate
- The interest rate on loans obtained
- The costs of acquiring funds

Table 10.1 below illustrates this with an example. A guarantee fund of 1,000,000 Euro is partly financed by equity and partly by loans with different interest rates. In this example the weighted average cost of funds is 5.35% p.a. which is 2.35% above the inflation rate. This rate includes the cost of acquiring funds, estimated here at 1% p.a. The annual cost of funds is 53,500 Euro.

**Table 10.1**  
**Example of calculation of cost of funds**

Source of funding of guarantee fund	Amount	Costs	Relative % of funding	Relative cost
Equity	€ 250,000	Inflation rate = 3% p.a.	25%	0.75%
Loan	€ 150,000	6% p.a.	15%	0.90%
Loan	€ 500,000	3% p.a.	50%	1.5%
Loan	€ 100,000	12% p.a.	10%	1.2%
<b>Total</b>	<b>€ 1,000,000</b>			<b>4.35%</b>

Source of funding of guarantee fund	Amount	Costs	Relative % of funding	Relative cost
Costs to obtain fund		1% p.a.	100%	1%
Total weighted average cost of funds				5.35%
<b>Annual cost of funds</b>	<b>€ 1,000,000</b>	<b>5.35%</b>	<b>100%</b>	<b>€ 53,500</b>

### 10.3 Losses on guarantee operations

The net annual losses on guarantee operations are the total amount of pay-outs to lenders minus the proceeds from recovery. Suppose that over time it is learned that annual net losses on guarantee operations are 1.5% of the average outstanding guarantee amount per year. This figure has to be added to the cost of funds and the operational costs of the guarantee fund, since all three cost factors have to be adequately covered by the income from fees and investments.

Net losses in efficient guarantee funds are below 2% of the average outstanding guarantee amount per year. If the rate appears to be less, the guarantee fund might be too conservative. If it goes over 3%, remedial action must be taken, since word can spread amongst the client groups and the fund will be depleted fast.

### 10.4 Operational costs

To provide banks and small entrepreneurs with credit guarantees, the guarantee fund incurs operational costs. Table 10.2 gives an example of the operational costs of a fictitious guarantee scheme.

**Table 10.2**  
**Example of operational costs**

Cost elements			Amount
Staffing	Number	Salary p.a.	Total
Appraisal staff	2	€ 9,000	€ 18,000
Collection staff	1.25	€ 9,600	€ 12,000
Director	1	€ 15,000	€ 15,000
Secretary	1	€ 7,000	€ 7,000
Accountant	1	€ 11,000	€ 11,000
Total staff costs			€ 63,000
Office rent			€ 6,000
Water and electricity			€ 800
Depreciation of equipment			€ 2,500
Transport			€ 1,000
Stationery			€ 2,000
Total non-staff costs			€ 12,300
Total operational costs			€ 75,300

## 10.5 Guarantee fees and administrative fees

In most guarantee funds, the guarantee fee is set as a percentage of the guaranteed loan amount, charged annually. Some guarantees schemes, however, define the fee as a percentage of the entire loan. In these schemes the same fee rate represents a higher cost for the client. For example, a 2% guarantee fee for a guarantee that only covers 60% of the loan amount in reality costs  $2 \times 100 / 60 = 3.333\%$ .

There are two ways to set the guarantee fee:

- *Setting the fee based on the prevailing market rate.* In most countries the fee is around 2% of the guaranteed loan amount per annum. Since the client has to pay this fee on top of the interest rate on the loan, it should not be much higher than 2%.
- *Setting the fee on the basis of costs.* This means taking the sum (S) of the annual cost of funds plus the annual cost of losses plus the annual operational costs. The annual sum (I) of the fees charged plus the annual returns on investment have to cover the sum of the costs. The guarantee fund operations are profitable when  $(I - S > 0)$ .

Table 10.3 gives an example of a fee calculation on the basis of costs. In this example the guarantee funds charges an annual guarantee fee of 2% on the guaranteed loan amount and an administrative fee of 1% of the newly issued guarantees. The guarantee fund makes an annual loss of 4,300 Euro.

**Table 10.3**  
**Calculating the guarantee fee**

Cost or income element	Amount
Size of the fund	€ 1,000,000
<b>Costs</b>	
Operational costs	€ 75,300
Costs of funds	€ 53,500
Net losses on guarantee operations	1.5% x 3,000,000 = € 45,000
<b>Total costs</b>	<b>€ 173,800</b>
<b>Income</b>	
Amount available for investments	80% x 1,000,000 = 800,000
Interest rate	12% € 96,000
Effective leverage	3

Cost or income element	Amount
Portfolio of guarantees	€ 3,000,000
Guarantee fee per annum	2% € 60,000
New guarantees issued	€ 1,350,000
Administrative fee	1% € 13,500
<b>Total income</b>	<b>€ 169,500</b>
Profit	- € 4,300 (loss)

The fee set by the guarantee fund can be related to the distribution of risk between the bank and the guarantee fund. The higher the coverage, the higher the probability of loss for the guarantee fund. This is because the higher the coverage, the greater the risk of moral hazard, since borrowers lose their incentive to repay when they feel that they are well covered by the guarantee fund. At the same time lenders lose their incentive for proper delinquency management because they know they are covered by the guarantee fund and have a relatively low exposure.

Apart from this, long-term loans are in practice more risky than short-term loans. As the time horizon extends, it becomes more difficult to predict the future. This is especially the case in some highly volatile less developed countries. A term premium can be added to compensate both the lender and the guarantee fund for this added risk. Table 10.4 gives an example of how fee rates can be set taking into account the risk coverage as well as the loan term.

**Table 10.4**  
**Fee structures**

Risk distribution (% coverage by guarantee fund)	Guarantee fee as % of the guaranteed loan amount	Addition for loans 3 to 5 years	Addition for loans 5 to 8 years
< 20%	0.80%	0.10%	0.25%
21 – 40%	1.20%	0.25%	0.50%
41 – 50%	1.50%	0.50%	0.75%
51 – 60%	2.00%	1.00%	1.50%
61 – 70%	2.50%	1.50%	2.50%
71 – 80%	3.00%	1.50%	2.50%

*Good practice:* Tables can be drawn up with very detailed fee rates, but it is advisable to limit the number of different levels to a minimum. Practice shows that one base rate with four variations is more or less sufficient.

### Case study: Fee rates in the Netherlands



The BBMKB Guarantee Scheme in the Netherlands charges a flat rate of 3% over the guaranteed loan amount, to be paid upfront. The discounted value is higher, depending on the length of the period for which the guarantee is valid. This system was introduced to reduce the administrative costs for the guarantee fund. Charging a flat rate at the moment of disbursing the loan means that the fund is assured that its money is paid. But it does mean a higher financial burden for the user right at the start of the investment.

*Good practice:* Charge an administrative fee to cover appraisal costs. This is easy to collect directly from the borrower when he or she applies. The amount can be either a fixed amount or calculated on the basis of the requested guarantee amount. Administrative fees are usually around 1% of the requested guarantee amount. Charging an administrative fee before deciding on granting the guarantee deters entrepreneurs who think they can obtain a loan more easily if they can present an ex-ante guarantee.

### 10.6 Return on investment

One of the most important sources of income for the guarantee fund is the income it receives from the investment of its funds. These funds will only be touched when there are claims from the participating banks for defaulting clients.

The income from this investment needs to be as stable and predictable as possible. At any time, the guarantee fund should have enough cash to pay the lender if there are claims. Risky investments should therefore be avoided. It is advisable to invest in safe investments like treasury bills or deposits with other stable formal institutions.

Some guidelines for fund investment:

- 10% to 20% of the fund can be invested in short-term treasury bills. This range is strongly affected by the leverage attained on the guarantee fund. The higher the leverage, the more funds need to be kept in liquid or near-liquid form in order to pay out claims.
- In countries with fluctuating exchange rates, it is advisable to keep some of the fund in foreign exchange to protect it against losses caused by devaluation.
- Deposits should only be made with reputable formal financial institutions, generally banks rated A+ or higher.
- No part of the fund should be invested in projects that do not yield a stream of income, however secure (for example real estate).

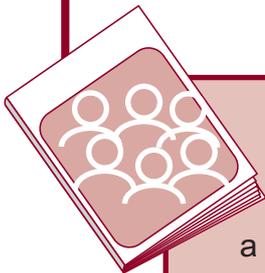
If fees charged and revenues from investments amount to more than the costs of the guarantee fund, the fund will make a net profit. The board of directors can then decide whether to use the profit for new investments (e.g. buildings, computer equipment, staff, promotion) or to plough it back into the fund for guarantees.

## 10.7 Do guarantee funds have to be financially sustainable?

Guarantee funds should ensure their own continuity, but is it necessary for them to strive for financial sustainability? This depends first and foremost on their objectives. Consider two different scenarios:

- i. The objective might be that the guarantee fund is to become financially independent from contributions from parties other than the clients. In this case, once the guarantee fund is established, income generated through fees and returns on investment must be sufficient to offset all costs.
- ii. If the guarantee fund has been established with macro-economic objectives in mind, and with a development focus, donors and management may consider losses to be justifiable. In this case, the promoters of the guarantee fund have to be prepared to assume a certain level of losses. But even here, a maximum limit for losses should be set and adhered to by management.

### ***Case study : When losses can be justified***



Losses can be justified from a macro-economic point of view. The Netherlands has a national guarantee fund which has had a tremendous macro-economic effect on the survival of the small enterprise sector. This on its turn increases social security payments made by employees, taxes, and import/export duties levied on goods and services sold and exported. The subsidy that is needed each year to keep the guarantee fund afloat is acceptable to the society as a whole because of the fund's macro-economic benefits.

Sustainability should not be pursued to the detriment of a guarantee fund's primary objective. Generally, the primary objective is to issue guarantees to lenders, bridge the gap between lenders and the targeted entrepreneurs, and to pay out lenders when guaranteed borrowers default. Therefore promoters of guarantee funds need to have a clear position on the question "What is more important: the financial sustainability of the *instrument* (= the fund), or the financial sustainability of the *client* ?"

A guarantee fund may be so concerned with being self-sustainable that it only issues a minimum number of guarantees, avoids risk and cuts down on its operating expenses. This practice could allow it to invest its profits, and in this way it may well generate a large financial income. Such a guarantee fund will indeed be sustainable, but its sustainability will have been achieved at the cost of its primary objective.

### 10.8 Why is financial sustainability seldom reached?

Many guarantee schemes struggle to become financially sustainable and independent from their promoters. There are a variety of reasons why funds do not reach financial sustainability:

- Guarantee fee set too low
- Guarantee facility underused
- Resources insufficient to issue many guarantees
- Low leverage
- Excessive or unsuitable staffing
- Tasks being duplicated by the guarantee fund and lenders
- Moral hazard on the part of the clients
- Poor or adverse selection of clients by lenders
- Weak recovery procedures on the part of the lender
- Lenders not bothering to repossess collateral
- Insufficient risk assessment and monitoring systems
- Overestimating the value of collateral
- Adverse legal, political or social environment.

## **10.9 Ways to improve sustainability**

There are a number of possible actions to improve financial sustainability and decrease dependence on promoters and financiers. They fall into two categories, increasing income and decreasing costs:

### ***Increasing income***

- Raise effective leverage (to be discussed with the lenders)
- Reduce transaction time (this will improve the attractiveness of the guarantee fund to clients)
- Increase guarantee fees
- Increase administrative fees
- Improve fund management
- Increase the capitalisation of the fund.

### ***Decreasing costs***

- Review all tasks carried out by the guarantee fund and avoid all unnecessary duplication of tasks carried out by lenders
- Increase the weighting of the ratio of guarantees issued between automatic/portfolio and individual guarantees in favour of automatic/portfolio (this will result in reduced operating costs)
- Decrease the risk coverage (this will reduce pay-outs)
- Improve risk assessment procedures (this will reduce pay-outs)
- Systematise collateral pledged by borrowers in favour of the guarantee fund
- Improve recovery procedures
- Diversify lenders or shift towards lenders who apply prudent risk assessment procedures.

**Workshop Exercise:**



To what extent are the problems mentioned in section 10.8 valid for the credit guarantee fund that you are familiar with? What methods to improve sustainability could be employed? Which of the actions listed in section 10.9 can or cannot be taken, and why?

# ACCOUNTING AND FINANCIAL REPORTING

## *This chapter:*

- *discusses the objectives of internal and external financial reporting*
- *presents the different financial reports that a guarantee fund should produce*
- *introduces aspects of guaranteeing that require specific recording*

## **11.1 The objectives of financial reporting**

Management, board and stakeholders have to be kept well informed of the performance of the guarantee fund and in particular its financial performance. This needs a proper accounting system and transparent reporting procedures. The quality of the reports is determined to a great extent by the quality of the accounting system, and even more by its reliability.

A financial accounting system should provide information on:

- The *size* and *quality* of the guaranteed portfolio
- The *liquidity position* of the guarantee fund – its capacity to cover its financial obligations in the short and medium term
- The *profitability* of the guarantee fund – its capacity to cover costs with its income
- The *financial structure* of the guarantee fund and its capacity for growth

This information is presented in the three levels of financial reporting:

- *Internal management reports* – these set out in detail all activities expressed in financial terms. The reports are produced weekly or monthly.
- *Reports to the board of directors* – these present more condensed management information and achievements on core indicators. The reports are produced quarterly or in advance of each meeting of the governing board.

- *Annual reports* – these are for shareholders, supervisory bodies, banks, borrowers and business associations. The annual report is an external report, and includes financial statements signed by an auditing firm.

The following other financial reports are needed for management to assess the functioning of the guarantee fund:

**Table 11.1**  
**Financial reports used by management**

Report	Objective	Key aspects
Liquidity forecast	To assess the capacity to cover obligations in the short and medium-term	Projection of 'cash in' versus 'cash out' (claims and recurrent costs; income from fees and investments)
Portfolio report	To assess the size and the quality of the guarantee portfolio	Overview of normal guarantees versus guarantees at risk and potential claims
Profit and loss statement	To assess the capacity of the fund to cover costs with income	Income and expenditure over the past period
Balance sheet	To assess the financial structure of the fund and how has it been financed	Overview of assets and liabilities at the moment of reporting

## 11.2 The liquidity forecast

Guarantee funds go bankrupt when they cannot meet their short term financial obligations – irrespective of their longer term profitability. If not enough cash is coming in on a regular basis to pay weekly or monthly expenses, a fund can be depleted fast.

The liquidity of a guarantee fund can fluctuate considerably. Some expenses, like staff salaries and interest on loans, have a regular character and can be anticipated accurately on a monthly basis. Other expenses, like pay-outs to

lenders, can have a more irregular character depending on the quality of the portfolio at each point in time.

On the revenue side, the situation is more complicated. Revenue is irregular for a number of reasons:

- The *income from guarantee fees* has a pattern which depends on the system of collecting fees. If the banks are paying the guarantee fees, they tend to do so quarterly or semi-annually. It is cheaper for the banks' administration to do this than to transfer fees to the guarantee fund on a case-by-case basis. In a portfolio scheme, the guarantee fund will receive the payments from the banks at the closure of a reporting period.
- The *income from investments* made (the interest earned on deposits) will usually be paid out at the end of certain fixed periods.
- Most *contributions or subsidies from third parties* are paid in advance, at least in the first year. Over the following years, additional funds will be disbursed on the basis of reports submitted to donor agencies.

### 11.3 The portfolio report

Issuing guarantees is probably the easiest task of the guarantee fund. But honouring claims is quite another thing. The fund can find itself depleted if the claims it has to pay to participating banks amount to more than its regular growth from investments, fees and proceeds from sales of assets.

Management has to be kept informed on a very regular basis about the state of the guaranteed portfolio – both the potential claims on the fund and the results of the sale of assets repossessed. Regular portfolio reports are needed to monitor the performance of the guarantee fund and its partner banks. Portfolio reports are also needed for the liquidity forecasts, since they are the basis for forecasting losses on the guarantee portfolio.

Tables 11.2 and 11.3 are examples of guarantee portfolio reports. The data for these reports are provided by the lenders, usually on a monthly basis. Table 11.2 shows the status of each guaranteed loan as well as the number of days since the first missed instalment was due. This “ageing report” enables the guarantee scheme to calculate its portfolio at risk.

Table 11.3 shows the follow-up on each individual client for whom a pay-out has been made. It shows the proceeds from recoveries as well as an estimate of the value of the collateral, taking into account the number of days since the pay-out was processed.

## Table 11.2 Report on the guaranteed loan portfolio

Name	Loan #	Total amount of loan	Balance of loan principal due as of (date)	Effective payments as of (date)	Balance of principal due but not paid	Interest due	Penalty interests due	Legal expenses due	Total amount due	Remaining principal outstanding	Total Amount due and owing (if Principal outstanding called in)	Number of days in arrears for the first missed instalment				Remarks
												1 to 30 days	31 to 60 days	61 to 90 days	91 to 120 days	
(1)			(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(11)	(11)	(11)	(12)

- (1) List of all borrowers to whom the lender has extended a guaranteed loan.
- (2) Balance of the loan principal due for payment as of (date) according to the initial repayment schedule.
- (3) Effective payments of principal made by the borrowers (borrower's account as the source of data).
- (4) Balance of principal due by the borrower and still unpaid (calculated as 2-3).
- (5) Contractual interests due on the unpaid principal (according to the repayment schedule).
- (6) Penalty interests charged by the lender in case of non-payment.
- (7) Legal expenses charged by the bank in order to recover the past amount due by the borrower.
- (8) Total amount due by the borrower (calculated as 4+5+6+7).
- (9) Amount of the remaining outstanding principal (i.e. principal not yet due for payment).
- (10) Total amount due if the remaining principal has been called in by the lender.
- (11) Number of days since the first instalment of the loan has been missed by the borrower (same amount as in column 8 or 10 depending if remaining principal called in or not).
- (12) Explanation on the extrajudicial actions carried out by the lender and explanations on the reasons behind absence of payments. This column should also include the type and the value of the collateral pledged by the borrower in favour of the lender.

**Table 11.3 Report on proceeds after pay-out**

Borrowers' name	Lenders' name	Amount paid by guarantee Fund	Net proceeds from recoveries	Renegotiated loan instalments due as of	Instalments paid as of	Balance due of renegotiated loan	Outstanding principal amount not yet due	Number of days since pay-out has been processed by the guarantee fund	Estimation of the value of the collateral	Remarks
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)

- (1) Each individual borrower for whom the guarantee fund has paid out to the lender should be listed.
- (2) Borrowers are listed per lender.
- (3) Amount paid by the guarantee fund to the lender in compliance with the guarantee contract or certificate of guarantee (pay-out).
- (4) Proceeds received by the guarantee fund on recoveries from the borrowers.
- (5) In some cases, the amount of the pay-out from the guarantee fund to the lender may be transformed into a 'loan' to the guaranteed borrower. Under such an agreement, the guarantee fund agrees the reimbursement of the amount due by the borrower under new terms and conditions. Amounts indicated in this column reflect the instalments due according to the repayment schedule.
- (6) Effective payments from borrowers.
- (7) Instalments due and unpaid.
- (8) Outstanding principal amount.
- (9) Number of days since the pay-out has been processed by the guarantee fund (this number of days is required so as to re-evaluate the value of the collateral provided by the borrower).
- (10) Estimation of the value of the collateral pledged by the borrower taking into account the number of days since pay-out has been processed so as to reduce the value of the collateral in the calculation of the potential final loss.
- (11) Remarks consisting mainly of an estimation of the final loss that the guarantee fund may record in its financial statements as well as the status of the legal actions carried out by the lender and by the guarantee fund.

## 11.4 The profit and loss statement

As mentioned earlier, the three main sources of income for guarantee funds are the interest received on investments, the guarantee fees and administrative fees, and the subsidies from third parties. The costs of the guarantee fund are the usual costs of running of a relatively small financial institution.

The main components of a profit and loss statement of a typical guarantee fund will therefore be:

### **Income**

- Income from guarantee fees
- Income from administrative fees
- Income from investments
- Proceeds from sale of repossessed assets
- Subsidies

*Note:* Equity contributions to the fund do not show in the profit and loss statement, but are recorded in the balance sheet. The subsidies recorded in the profit and loss statement are those covering the operational costs, for example rental subsidy.

### **Costs**

- Salaries and wages of staff
- Administrative expenses
- Rent of premises
- Publicity and promotion
- Marketing
- Depreciation of office equipment
- Training costs of staff
- Financial costs
- Claims paid out

Deducting all the costs from the income gives us the operational loss or profit of the organisation before taxes.

## 11.5 The balance sheet

The main items on the balance sheet of a typical guarantee fund are:

### **Assets:**

- Cash
- Bank
- Receivables: unpaid fees
- Other receivables (accrued income)
- Investments
- Fixed assets
- Other assets (if any)

### **Liabilities:**

- Creditors: outstanding claims by lenders
- Other creditors (suppliers, taxes, accrued expenses)
- Loans owed by the guarantee fund
- Funds administered by the guarantee fund

### **Capital:**

- Fund for guarantees
- Legal reserve
- Other reserves
- Retained earnings

To interpret the balance sheet of a guarantee fund, one needs to look carefully at certain key items:

- *The collection policy for guarantee fees and administrative fees.* The more credit the organisation is willing to give to the small entrepreneurs or the banks, the higher the receivables.
- *The ownership of the funds to back the guarantee portfolio.* The ratio liabilities/capital on the balance sheet will look very different depending on whether the funds are merely administered by the guarantee fund or whether they are owned by the fund as equity.

- *The quality of the loans obtained.* If these loans have a subordinated character it is worthwhile to appraise the condition of subordination. If it is clearly stipulated that these loans are not to be repaid and claims can be charged to them, they can be considered as quasi-equity.
- *The ratio between funds deposited and cash at hand.* To what extent has management properly invested its funds to generate sufficient revenue compared to funds needed to pay out claims?

### 11.6 The recording of guarantees issued

When banks lend to small enterprises, these loans appear in their balance sheets under accounts receivable. The guarantees that a guarantee fund issues, however, do not appear on their balance sheets. They only appear in the guarantee portfolio report, which can be regarded as an attachment to the balance sheet. The balance sheet and the guarantee portfolio report should therefore be read in combination so as to give management a full picture of the real financial position.

The issuing of guarantees does, however, bring about certain changes to the balance sheet. In the short term, guarantees create the obligation for the small entrepreneur to pay the guarantee fee. This will be noticed in the balance sheet only when fees have *not* been paid. The unpaid fees will then appear in the balance sheet as receivables - unpaid fees.

### 11.7 Provisions

A guarantee fund is a provision in itself, so there is no need or requirement to make a provision for potential losses. Only in non-funded schemes is it advisable to make provision for potential claims per annum, and here it is acceptable to make an estimate.

The fact that there is no need for provisions does not imply that the fund, for reasons of prudence, should not take a careful assessment of the quality of its portfolio. Portfolio quality assessment is always needed to monitor the performance of the guarantee fund as a whole and to determine the desired level of leverage.

An ageing report is the best tool to assess the quality of the portfolio, and serves as a basis to estimate possible losses to be charged to the fund. Chapter 12 gives examples of portfolio at risk calculations.

## 11.8 Contributions to the fund

Many guarantee funds for small enterprises have funds received from donors for the specific purpose of issuing guarantees. It is common practice to include these funds under “Capital” as “Fund for Guarantees”. The Fund for Guarantees is part of the equity of the guarantee fund and all losses/results generated during an accounting period are added back to this equity after taxes have been paid.

Often donor agencies do not formally transfer these funds but just indicate that eventually the funds might become property of the guarantee scheme. In such cases the donor funds do not appear under equity but under “Liabilities” as “Funds in Administration”.

*Good practice:* In circumstances where inflation is high, it is advisable to make corrections on the value of funds used to back guarantees. This is particular relevant if the guarantees are issued with a clause stating that the value of the guarantee must be indexed to inflation.

*Good practice:* Look carefully into the conditions of agreements with funding organisations. They may well stipulate that any funds in administration need to retain their original value. This stipulation needs to be viewed particularly carefully in relation to foreign exchange risks.

## 11.9 Subsidies

Because many guarantee funds find it difficult to generate sufficient income to cover operational costs, third parties sometimes pay additional subsidies. It is a common practice for governments or development organisations to make additional contributions to keep a guarantee fund afloat. Subsidies can also come from the small business sector itself or from participating banks. Socially responsible business practices may also induce larger companies to support guarantee funds for small enterprises.

When subsidies are received in advance, as they normally are, they should be recorded in the balance sheet under “Short-term liabilities”. At the end of each reporting period, the amount that corresponds with the costs that the subsidy was expected to cover is debited, and this enters the profit and loss statement for that period.

## 11.10 Reserves

A “Legal Reserve” account must be established if the law or the regulatory authorities require it. The legal reserve represents a certain amount of profit, which by law has to be credited and retained in a separate reserve account. Other reserves are established in accordance with the prudential regulations of the guarantee fund. Reserves are shown under “Capital” in the balance sheet.

## 11.11 Management information systems

Management information systems (MIS) supply information based upon the specific requirements of a guarantee fund. MIS should provide the following information:

- Number and values of guarantees issued
- Value and number of claims
- Status of recovery of guarantees
- Status of legal proceedings
- Position of the fund in respect of its liquidity
- Financial statements

Normally, guarantee funds design and develop their own MIS and database systems to ensure that they are in line with their policy and objectives. There are no standard systems that can be procured directly on the market.

*Good practice:* Design the MIS system in consultation with the participating banks. They might be in a position to provide the guarantee fund with modules from their own MIS systems. This will also make it easier to link the participating banks’ reporting directly to the MIS of the guarantee fund.

## PERFORMANCE MONITORING

### *This chapter:*

- *describes indicators that can be used to monitor the financial performance of a guarantee fund*
- *describes indicators that can be used to monitor the socio-economic performance of a guarantee fund*

### 12.1 The need for performance indicators

One of the tasks of management is to constantly check whether the guarantee fund is on course to achieve its objectives. Performance indicators are a powerful way of doing this. They generate the data to monitor developments over time and to compare actual results with the targets which were originally set. Performance indicators are important tools for decision-making and corrective action.

Guarantee fund performance often has to meet two sets of objectives – financial objectives and social objectives. *Financial indicators* demonstrate portfolio quality and efficiency. *Socio-economic indicators* describe factors like the numbers of clients that have been able to access a loan as a direct consequence of the guarantee scheme.

### 12.2 Financial performance indicators

The basic indicators necessary to evaluate the financial performance of the guarantee fund internally are:

**Table 12.1**  
**Financial performance indicators**

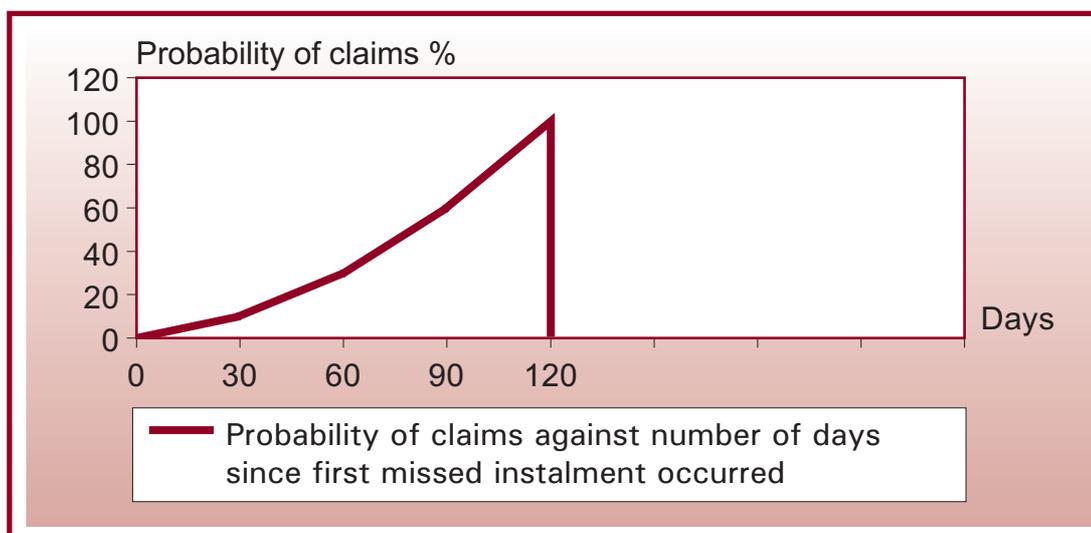
Indicator	What it measures	How it is calculated
Transaction cost per Euro of guarantee issued	Operational efficiency	Operating costs over a certain period, divided by the total amount of guarantees issued over that period. Transaction costs can also be expressed as a cost per guarantee issued.
Pay-out rate	Losses incurred	The value of pay-outs over a year, divided by the average outstanding guarantee amount over that year. The pay-out rate is calculated for each lender separately. Good ratios should be below 3% and should never exceed 7% in a fully established guarantee fund.
Net loss rate	Net losses incurred	Pay-outs minus proceeds from recovery over a year, divided by the average outstanding guarantee amount over that year. This ratio is calculated for each lender separately. Good ratios are below 2%.
Recovery rate	The capacity of both lender and guarantee fund to recover losses from borrowers after claims	Proceeds from recoveries, divided by pay-outs. Ratios are calculated for each lender individually. A good ratio should be higher than 20%.
Guarantee portfolio at risk	Portfolio quality	The total amount of guaranteed portfolio overdue, divided by the total outstanding guaranteed portfolio.
Average number of days taken to issue a guarantee	Operational efficiency	The number of days from the moment the borrower presents him/herself to the guarantee fund, to the moment that the guarantee is issued (this indicator only applies for individual guarantees).

Indicator	What it measures	How it is calculated
Average number of days to pay out a claim	Operational efficiency	The number of days from the moment the bank sends a claim to the guarantee scheme, to the moment the claim is settled.
Leverage	Effectiveness	The amount of guaranteed loans extended divided by the capital of the guarantee fund.
Number and value of guarantees issued	Effectiveness	These numbers have to be compared with the set targets.

### 12.3 Portfolio at risk

A portfolio at risk calculation is a measure of the maximum possible total loss that a guarantee fund may suffer at a particular point in time. It is calculated as the ratio of total guaranteed portfolio overdue divided by the total outstanding guaranteed portfolio.

**Figure 12.1 Probability of claims against number of days since first missed instalment**



Another way of calculating the portfolio at risk is based on the number of days since the first missed instalment of overdue loans. This is based on the fact that the probability of claims goes up with the number of days since the first missed instalment occurred, as illustrated in figure 12.1.

Portfolio at risk can thus be calculated as:

$$\begin{aligned} & 2\% \text{ on outstanding guaranteed loan amounts not in default} \\ & \quad + \\ & \quad 10\% \text{ on 1 to 30 days in arrears} \\ & \quad + \\ & \quad 30\% \text{ on 31 to 60 days in arrears} \\ & \quad + \\ & \quad 70\% \text{ on 61 to 90 days in arrears} \\ & \quad + \\ & \quad 100\% \text{ on 91 to 120 days in arrears} \end{aligned}$$

Portfolio at risk is then the above total divided by outstanding guarantees.

If the portfolio at risk is given as an indicator in a financial report, it is important to provide the reader with information on how the portfolio of risk was calculated.

### 12.4 Socio-economic performance monitoring

For guarantee funds for small enterprises, the most common indicators of socio-economic success are the number of enterprises that make use of the guarantee fund and the annual growth of this number. These two indicators should also be related to the overall growth of the sector.

If the original incentive to launch a guarantee fund was macro-economic, the assessment of its effects should also be related to macro-economic objectives. Take for example a situation in which a government wishes to stimulate young graduates from technical schools to start their own businesses. Lack of collateral might be a limiting factor blocking access to formal financing, and so the government decides to establish a guarantee fund. Future monitoring and evaluation of this fund should focus on indicators related to the original criteria – in this example, the number of young graduates who actually obtained financing. Then, to find out the overall macro-economic effect of the guarantee scheme, the assessment should go further, and attempt to measure the overall added value of these new entrepreneurs to society.

Another important socio-economic indicator is the growth (by sales volume or employment) of enterprises that receive loans supported by guarantees, compared to a control group who did not receive guaranteed loans. Collecting this information on a continuous basis may be too costly for most guarantee funds, but it is recommended that guarantee funds undertake this assessment at least every couple of years as part of their periodic evaluation.

Often guarantee funds are set up to stimulate banks to lend to small enterprises. This is usually done when banks are active in other sectors but have no real incentive to focus on the small enterprise sector. A simple yardstick of success here would be the number of banks which participate in the guarantee programme and actively lend to the small business sector. (Of course this is only a useful indicator only if there are a relatively large number of banks available to participate). Another indicator of success would be the outreach of participating banks over the country.

## 12.5 Additionality and graduation

Two specific indicators are used to find out whether a guarantee mechanism has had a positive effect on bank lending to the target group:

- *Additionality* – the number of clients who received a loan from the participating banks as a result of the guarantees issued.
- *Graduation* – the number of clients who received a loan with a guarantee and who later became ‘normal’ clients of the banks (i.e. without guarantees).

*Additionality* is defined as the number of clients who received formal credit as a result of the guarantee issued. In practice it is very difficult to truly determine whether a lender has approved a loan because of the guarantee or whether the lender would have provided a loan to the client anyway. In some instances banks may be just using the guarantee fund as an additional source of collateral. It would therefore be misleading for guarantee funds to simply assume that all loans guaranteed would not have been disbursed in absence of the guarantee. Difficult as it is to measure, an accurate estimate of additionality is essential if guarantee funds are to market themselves to donors and government ministries.

One can get a better picture of additionality from data from the lending institutions. Some lenders quantify the extent to which their lending to targeted borrowers has increased since signing the guarantee contract. This may still overstate the additionality, as this sector of lending might have increased

anyway, but it is nevertheless useful. Reports on additionality are sometimes provided by lenders on a regular basis. They are commonly requested prior to a periodic evaluation exercise.

Another way of estimating additionality is to approach lenders directly, before or after a guarantee scheme starts, and ask how they would behave (or would have behaved) in the absence of the fund. Replies should be treated with caution, as lenders may try to overstate the impact of guarantees.

*Graduation* means that a borrower who once needed a credit guarantee is now able to borrow from the same lender without a guarantee. This is sometimes structured as a progressive transition, in which successive loans attract lower percentages of guarantee, until the borrower's own collateral is sufficient to cover the lender's requirements in full. As part of a guarantee fund's evaluation, lenders should be asked to list all previously guaranteed borrowers who are now provided with a credit without the need of a third party guarantee.

The degree of graduation indicates that borrowers are benefiting from access to credit and can expand their enterprises. It also demonstrates that lenders do not regard the guarantee fund as a permanent means of minimising their exposure to risk.

Bear in mind that both lenders and guarantee schemes have incentives not to promote graduation. The lenders' incentive not to graduate borrowers is because lenders have lower risk exposure when loans are guaranteed. Guarantee schemes, for their part, have an incentive to encourage their more successful entrepreneurs to continue relying upon a guarantee, as these entrepreneurs represent a lower risk to the scheme and provide reliable fee income. To compensate for this tendency, both lenders and the guarantee fund should agree on the criteria used for the risk appraisal, so as to avoid extending guarantees to clients who do not need them anymore.

## Workshop Exercise:



For the fictitious guaranteed loan portfolio presented below, calculate the portfolio at risk, following the two different methods presented in section 12.3.

Name	Loan #	Total amount of loan	Balance of loan principal due as of (date)	Effective payments as of (date)	Balance of principal due but not paid	Interest due	Penalty interests due	Legal expenses due	Total amount due	Remaining principal outstanding	Total amount due and owing (if Principal outstanding called in)	Number of days in arrears for the first missed instalment				Remarks	
												1 to 30 days	31 to 60 days	61 to 90 days	91 to 120 days		
	1	5,000	4,000	4,000	-	-	-	-	-	1,000	-	-	-	-	-	-	-
	2	10,000	7,000	6,000	1,000	100	100	-	1,200	3,000	4,200	X	-	-	-	-	-
	3	8,000	6,000	6,000	-	-	-	-	-	2,000	-	-	-	-	-	-	-
	4	5,000	4,000	2,000	2,000	200	200	100	2,500	1,000	3,500	-	-	-	-	-	X





### ANNEX I: CLAUSES COMMON IN AN INDIVIDUAL GUARANTEE CONTRACT

The following clauses usually appear in a guarantee contract:

Descriptions of the borrower, the loan size, the loan term, the repayment pattern and the interest rate charged on the loan.

Descriptions of the collateral and personal guarantees pledged by the borrower and other guarantors.

A description of how much is covered by the guarantee fund. This can be expressed either in monetary terms (an amount fixed or decreasing over the loan period) or as a percentage of some of the loan components (principal, interest, penalty interest). In cases where interest or penalty interest is covered by the guarantee fund, the contract should specify a maximum number of months after the first missed instalment over which the lender can claim interest.

The duration of the guarantee (usually the same as the loan term).

A clause specifying that the guarantee fund is subsidiary liable, its liability being confined to a percentage of the loan losses made after the deduction of proceedings from collateral and from personal guarantors.

A clause that specifies the fees to be paid by the lender or the client to the guarantee fund, the timing of the payments and the method of payment.

A clause that specifies that if the guarantee fee has not been paid, the guarantee is invalid.

A clause that specifies whether or not the guarantee fund will refund fees paid by the lender or the borrower for unexpired periods of coverage in case of termination of the guarantee contract due to claims or due to other reasons.

A clause that specifies the type of information that the lender has to submit to the guarantee fund on the guaranteed loan, as well as the reporting timeframes.

A clause that gives the guarantee fund the right to access the loan files of the guaranteed borrower.

A clause that spells out that the lender is only allowed to restructure or reschedule the loan if there is prior authorisation from the guarantee fund.

A clause that specifies the conditions under which the lender can call in the claim, for example when all the following have happened:

- arrears have reached 90 days
- defaulters have been appropriately warned
- the loan has been called in
- legal proceedings have been initiated to foreclose on collateral and to recover loan debt.

A clause that limits the time period within which lenders can call in claims, for example the lender has to call in the claim within 40 days after the arrears have reached 90 days and the loan has been called in.

A description of the documents that should accompany a claim:

- photocopy of the loan document
- photocopy of the court writ
- photocopy of the payment order(s)

The criteria for rejecting claims, such as:

- the lender did not pay the fees
- the lender restructured or rescheduled the loan without authorisation from the guarantee fund
- the claim was presented beyond the agreed period
- the loan was disbursed before the guarantee was approved

A clause that specifies the maximum number of days for the settlement or the rejection of the claim by the guarantee fund.

A clause that specifies the method of payment for the settlement of claims.

A clause that specifies how proceeds from collateral will be divided between the lender and the guarantee fund.

A clause that specifies a time period after the recovery of collateral, within which the lender is to transfer the amounts owed to the guarantee fund.

A clause that specifies that the guarantee fund, after paying a claim, is entitled as a new creditor to designate its own representative to jointly repossess, with the lender's representative, assets from the client and/or personal guarantors.



### ANNEX 2: CLAUSES COMMON IN A PORTFOLIO GUARANTEE CONTRACT

Apart from the clauses that also appear in an individual guarantee contract, the following clauses commonly appear in a portfolio guarantee contract:

The eligibility criteria for guaranteed loans.

A clause that specifies the maximum sum guaranteed per loan contract.

A clause that specifies the maximum total outstanding guarantee amount.

A clause that specifies the maximum portfolio at risk amount.





## GLOSSARY

<b>Additionality</b>	The increase in the number of borrowers that are provided with formal credit as a consequence of the guarantee fund.
<b>Adverse selection</b>	In the context of a portfolio guarantee scheme: a situation in which the lender tends to include only high-risk borrowers in the guarantee scheme.
<b>Call in a guarantee</b>	When the lender requests payment from the guarantor.
<b>Collateral</b>	A specific property or asset that a borrower pledges as security for the repayment of a loan. The borrower agrees that the lender has the right to seize and liquidate the asset to recover the debt in case the borrower fails to repay the loan.
<b>Co-variant risk</b>	In the context of a guarantee scheme: a situation in which a large number of clients are subject to the same risk.
<b>Credit guarantee</b>	An agreement by a guarantor to meet the loan commitment of a borrower in total or in part if the borrower does not fulfil the commitment.
<b>Default</b>	Failure to meet the obligations of the loan contract. Usually lenders classify loans as being in default after a certain number of days (commonly 90 or 120) have passed since the first missed repayment.
<b>Delinquency</b>	Failure to meet the obligations of the loan contract.
<b>Eligibility criteria</b>	In the context of a guarantee scheme: criteria that define who can apply for a credit guarantee and who cannot.
<b>Equity participation</b>	Ownership interest in a business.

<b>Ex-ante guarantee</b>	Guarantee that is obtained from the guarantee scheme before the client has negotiated a loan with the lender.
<b>Ex-post guarantee</b>	Guarantee that is obtained from the guarantee scheme after the client has negotiated a loan with the lender.
<b>Graduation</b>	When borrowers who once needed a guarantee from a third party to borrow from a lender are now able to borrow without a third party guarantee.
<b>Guarantee fee</b>	Amount to be paid to obtain the guarantee coverage.
<b>Guaranteed loan</b>	A loan for which a third party (a guarantee fund) guarantees repayment to a lender in case the borrower fails to repay.
<b>Individual guarantee scheme</b>	Guarantee scheme in which the guarantee fund screens each individual client before issuing guarantee certificates.
<b>Liquidation of collateral</b>	The seizing and selling of collateral to pay to creditors.
<b>Moral hazard</b>	Risks or dangers that derive from human nature, which increase when, within an agreement between parties, incentives exist for one or more of the parties not to comply.
<b>Leverage</b>	In the context of a guarantee fund: the value of guaranteed loans extended divided by the capital of the guarantee fund.
<b>Liquidity position</b>	The ability of a firm to meet its short-term obligations on time.
<b>Pari passu</b>	At an equal rate of pace, in the same proportion.
<b>Penalty interest</b>	Extra interest charged on missed loan instalments.



<b>Personal guarantee</b>	A pledge by a third person to stand guarantee for a borrower's loan.
<b>Portfolio at risk</b>	The total outstanding loan amount that is overdue divided by the total outstanding loan amount.
<b>Portfolio guarantee scheme</b>	Guarantee scheme that issues contracts with lenders to guarantee a certain part of the loan portfolio depending on certain eligibility criteria.
<b>Provision</b>	In the context of accounting: an amount charged against profit to recognise the decline in the value of an asset such as a doubtful loan.
<b>Rescheduling of loans</b>	Changing the time schedule of the loan repayments.
<b>Subsidiary liability</b>	Only being liable for those obligations that those who are primarily liable cannot cover.
<b>Subordinated loan</b>	Loan over which other loans have priority. In the event of bankruptcy, subordinated loans are only paid back after more senior loan claims have been paid in full.





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