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CREDITOR GUARANTEE FUNDS FOR THE BENEFIT OF SMALL AND MEDIUM ENTERPRISES (SMEs) IN DEVELOPING COUNTRIES

Study prepared at the request of the UNCTAD secretariat by Technical Credit Insurance Consultants, S.A. Brussels, Belgium*

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* The views expressed in this study are those of its authors and do not necessarily reflect those of the UNCTAD secretariat.

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INTRODUCTION

(i) The Standing Committee on Developing Services Sectors: Fostering Competitive Services Sectors in Developing Countries - Insurance, decided at its first session, in February 1993, (item B,1, para. (d) of its work programme), to "prepare a comprehensive study including:

> Information arising from exchange of experience on ways and means to develop creditor insurance for the benefit of small and medium-size enterprises in developing countries to facilitate their access to credit from the financial system."

(ii) At its second session, in July 1994, the Standing Committee - Insurance made the following suggestion (Recommendations, para. 5):

> "... aware of limitations in available resources and time constraints, suggests that the secretariat investigate ways and means to develop creditor insurance (i.e., default in the repayment of a loan in respect of certain defined contingencies) for the benefit of small- and medium-size enterprises in developing countries and encourages an exchange on this issue".

(iii) In response to the suggestion of the Standing Committee (Insurance) the UNCTAD secretariat invited Mr. Jean-Paul Gason, Director of Technical Credit Insurance Consultants, S.A. Brussels, Belgium, to prepare the present study.

(iv) The purpose of this study is to survey the various existing machinery for the establishment and operation of loan guarantee funds for the benefit of small and medium enterprises (SMEs).

(v) In both developing countries and industrialized economies, SMEs constitute a genuine source of growth that is vital to economic development. If they are to play their role, however, such enterprises require capital for the financing of their projects. In most countries, financiers, and the banks in particular, do not pay sufficient attention to the SME sector. It is consequently often very difficult for a small size enterprise to secure bank loans on satisfactory terms. Denial of credit is frequently based on the absence of genuine security. In other cases, the small size of the loan sought may constitute a handicap for the applicant, inasmuch as many financiers do not lend below a certain threshold. A large number of SMEs throughout the world are directly affected by this phenomenon.

(vi) Being aware of the importance of SMEs in national economies, an increasing number of governments and international financial institutions have taken the initiative of setting up specialized machinery designed to encourage the commercial banks to cooperate with small enterprises by furnishing them with guarantees against any default on loans made to this category of customer.

(vii) It is very often the State which takes the initiative of establishing creditor guarantee funds for the benefit of SMEs and in most cases such funds are regarded as being in the public interest. They generally aim to cover a large target: SMEs as a whole, regardless of the different sectors in which they operate. There are also guarantee funds which operate in the context of a particular sector (e.g. agricultural credit guarantee funds, coffee producers' credit guarantee funds, etc.), but not much attention will be devoted to them here because such funds are not sufficiently concerned with SMEs as a whole, the primary focus of the present study. However, there is an increasing tendency to set up guarantee funds that are different in targeting a very specific market: microenterprises. The latter, generally formed of a single person or a nuclear family, are often very active in the area of handicrafts and in the informal sector. In Latin America, in Africa and in Asia, funds of this type have been set up on the initiative of multilateral institutions.

(viii) The present study examines the concept of creditor guarantee funds for the benefit of SMEs, traces the link with other forms of protection against default in payment, and creditor insurance in particular, describes some practical examples of such funds throughout the world, and presents a novel form of fund such as might be set up in many countries.

Chapter I

RAISONS D'ETRE OF CREDITOR GUARANTEE FUNDS FOR THE BENEFIT OF SMALL AND MEDIUM ENTERPRISES (SMEs)

A. The requirements of SMEs

1. Small and medium enterprises, whatever their geographical situation or sector of activity, all help to ensure a balance within society and in the economy. Not only do they help to create employment, they also enable major enterprises which make use of their expertise and specialized services to produce goods more efficiently and at lower cost.

2. For commercial banks, granting medium- or long-term investment credit to SMEs entails very specific risks. 1/ In the first place, such enterprises often do not have sufficient equity capital. As a result, they rarely finance their fixed investment with long-term capital and therefore resort largely to short-term finance for meeting their long-term needs. Secondly, the success of SMEs is often largely based on a single individual, the entrepreneur. Should any health or family problems affect the latter, they may well compromise the progress of his activities or, more seriously, threaten the survival of his enterprise. Thirdly, SMEs, precisely because of their smaller size and their limited equity capital, are more exposed than are other enterprises to uncertain economic conditions. Moreover, they are the ones which usually show the highest bankruptcy rate. Consequently, it is not always easy for commercial banks to determine the future prospects of SMEs and to estimate their capacity to repay loans.

3. Commercial banks and other financial institutions are usually accustomed to working with major enterprises and rarely have a department specializing in transactions with SMEs. In fact, the banking sector generally displays a lack of interest in SMEs. This is particularly true in the developing countries and in central and eastern Europe, notwithstanding the fact that enterprises of this type are often the most dynamic element in the economy.

4. For many commercial banks, the administrative costs of managing transactions with SMEs are relatively high in relation to the amounts financed. As these costs absorb an appreciable proportion of profit margins, the banks have no incentive to work with SMEs. In fact, some of them do not hesitate to charge higher interest rates to such enterprises. This practice - which is common in central and eastern Europe - tends to dissuade entrepreneurs from applying to the banking sector.

5. Most SMEs do not have sufficient assets in the form of tangible security or personal guarantees, having regard to the funds they seek for execution of projects. Consequently, a conventional financial evaluation precludes granting the funds applied for, even if the project has a real potential to succeed.

B. <u>The principles of the guarantee</u>

6. In order to encourage commercial banks and other financial institutions to grant loans to SMEs, credit guarantee schemes have been developed in many countries on the initiative of their Government or on that of international agencies, as well as at the request of representative professional associations.

7. There is no question of such guarantee funds approving any project submitted by an SME. Here too the borrower must fulfil a number of criteria laid down by the fund. These criteria will be considered later in this study. Experience shows that only viable projects should benefit from the support of a guarantee fund, which cannot simply be given to any applicant who presents himself. Such funds perform primarily the role of social regulator of the economy by assisting the launch of viable projects that will produce a beneficial fallout for the community. Had such funds not existed, millions of entrepreneurs throughout the world would generally have been unable to carry out their projects.

8. The solidity of the guarantee offered by such funds enables the lenders to take more account of socio-economic criteria and to grant loans in cases where purely financial criteria would not have sufficed.

C. <u>Financing requirements</u>

9. In considering the question of the provision of guarantees, particular attention must be devoted to the systems that exist in developing countries for meeting the financing needs of SMEs. Increasingly, in addition to the traditional banking system, there are facilities established by international institutions for the purpose of facilitating access to credit by SMEs. The mere existence of a guarantee fund is often not enough to resolve the difficulties encountered by entrepreneurs in finding financing arrangements. The cumulative costs of the loan and the guarantee are generally exorbitant and beyond the entrepreneur's means. In order to deal with this problem, institutions such as the World Bank and the Inter-American Development Bank have set up special lines of credit for SMEs. These lines of credit are established in the countries concerned through the Apex 2/ credit provision systems. These arrangements make it possible to reduce the cost of borrowing and make loans more accessible for small entrepreneurs. It should be noted that, in order to succeed, such initiatives must have the active participation of the local commercial banks for the channelling of loans. This channelling can also be effected through NGOs (non-governmental organizations), which, because of their acquaintance with the sector involved and their proximity to the local applicants for loans, are able satisfactorily to evaluate the needs and the risk. Such systems are often to be found in the remoter regions of Africa, Asia and Latin America.

10. As regards interest rates, the World Bank has always pursued a policy of opposition to subsidization of interest rates which distorts the free play of the market. Clearly, however, while subsidization of rates in favour of SMEs. is undesirable, this does not preclude the development of means of correcting harmful market effects that give rise to an artificial inflation of credit

costs. While commercial banks must be able to apply a rate enabling them to cover their costs and earn a profit, this does not mean that they should raise their profit margins excessively by setting exorbitant rates.

11. Some international institutions have encouraged the setting up in different countries of funds engaging in the dual activity of providing both financing and guarantees.

D. Technical assistance for SMEs

12. It is essential to give thought to helping SMEs through provision of technical assistance or through help in the formulation of their projects. To ensure efficiency, it is not sufficient merely to establish special lines of credit or a guarantee fund for the benefit of SMEs. Help for such concerns, including microenterprises, should be envisaged in the form of a global approach including sources of financing, guarantees and technical assistance.

13. The provision of effective guidance to entrepreneurs is a means of ensuring success for their projects. Certain funds have therefore set up technical assistance services, often financed by multilateral institutions, which supervise the execution of projects benefiting from guarantees or special financing arrangements.

E. Microenterprises - a special case

14. It is not surprising to note that microenterprises, to an even greater extent than SMEs, have to confront major obstacles in seeking credit. In Latin America and in the Caribbean region the microenterprise sector employs one worker in every three, while in the principal towns 50 per cent of workers are employed in such concerns. 3/ Because of the formal sector's small size, microenterprises constitute a viable work alternative for millions of people.

15. Here again, the problems that arise in connection with financing are due to the lack of tangible security. Because of their inherent characteristics, microenterprises frequently have only informal assets (property without title documents, machines with different utilization cycles and/or lacking documents proving ownership). Even where formal assets do exist, they often cannot be taken into account by the banking sector. They generally consist of personal motor vehicles, microcomputers or buildings in more or less satisfactory condition but situated in poorer areas.

16. Where there do exist funds that furnish security for loans to microenterprises, they are generally made available by the Government, through international cooperation and/or by means of a commission levied on the profits of commercial banks.

Chapter II

OPERATION OF CREDITOR GUARANTEE FUNDS FOR THE BENEFIT OF SMEs

A. Form of guarantee funds

17. Creditor guarantee funds for the benefit of SMEs may assume different juridical forms. When they are the result of a State initiative, as is generally the case, they will usually be within the public sector. They then form part of the Ministry of Finance or the Ministry of Economic Affairs. Sometimes the State wishes to allow the fund greater management independence and it then uses the form of an incorporated company. This is not the most appropriate approach for a guarantee fund for the benefit of SMEs because, behind this appearance of a private corporation, obviously only very few funds will manage to survive without the financial support of the State. A solution that is likely to prove more successful than this consists in making the fund a non-profit making association or enterprise.

18. We shall not consider here guarantee funds of a corporatist nature set up on the initiative of a profession, such as stockbrokers or construction firms. The aim of the promoters of such funds is often to improve the standards of the particular profession concerned. The legislator often takes the initiative, moreover, by laying down the statute of such funds and by making every member of the profession concerned contribute to them, examples being the case of guarantee funds set up by banks or by notaries. In these two cases the State has to protect depositors, and particularly small savers, against possible defaults - including malpractice - by members of a particular profession or sector. This type of fund will not be referred to further in the present study as it falls outside the latter's scope.

19. In the context of aid for SMEs, the presence of the State will be seen as essential to the satisfactory operation of such funds.

20. The administration of one or more guarantee funds may be entrusted to a specialized body which manages it or them on behalf of the State. Expertise in the provision of guarantees for the financing of SMEs can thus be concentrated in one place.

B. The guarantee offered

21. The guarantee offered by the fund may be comprehensive or partial. From the standpoint of risk management, a philosophy based on bank-fund partnership is recommended. This implies a sharing of the risk with the provider of finance. The latter is often invited to assume responsibilities as provider of the credit. This is a positive factor for the fund in exercising judgement, for the latter will know that any default by the debtor will also have a direct impact on the banker. This should encourage the latter to exercise greater prudence in granting loans. Only too frequently, guarantee funds which, in offering a comprehensive guarantee, did not take this factor into account have paid the price of such a policy, which inexorably leads to an overly-accommodating attitude on the part of the banks. We must therefore place emphasis on the principle of risk sharing.

22. Experience throughout the world has shown that the funds with the best performance are those which have insisted on a sharing of risk with the banker. Performance here refers to the fund's corporate objective, namely support for SMEs, an essential factor in national economic growth. Adoption of this approach enables the fund to function for a longer period, while requiring a more limited contribution from the State and offering the services of the fund to a greater number of applicants. Commercial banks are often reluctant to assume themselves part of the risk of loans to their clients. This is particularly true in countries where the banking sector is only beginning to develop and adopts a conservative approach.

23. The proportion of the capital guaranteed by a guarantee fund varies from country to country and even from one project category to another. It is generally between 50 per cent and 80 per cent.

24. One point to be determined by the manager of a guarantee fund is the maximum share of the risk which the banker will be prepared to assume. This share should not be too high, because the banker would then tend to submit to the fund only credits involving abnormally high risks. On the other hand, too low a guarantee share would give the banker no incentive for he would then have little desire to make certain loans. As a rule, the financial institution will be invited to retain between 20 per cent and 25 per cent of the risk, which appears reasonable.

25. The guarantee may relate both to the principal amount of the loan granted and to the interest. Some funds exclude cover of interest, while others accept it. The debate on this issue remains open and each fund has its own approach. However, as in the field of insurance, it is necessary to make sure that the guarantee offered by the fund cannot constitute a source of enrichment for the bank. Consequently, if there is interest cover, this can be only partial and may in no case cover the banker's possible opportunity cost in respect of a non-performing loan.

C. Cost of the guarantee

26. Most of the guarantee funds require payment of a premium in exchange for the cover granted. In addition to covering remuneration of the risk, this premium may also include various administration cost items. By this is meant any cost of obtaining information concerning a given risk, and the cost of studying and processing the risk file.

27. The premium generally ranges from 1 per cent to 3 per cent, calculated on the value of the loan. There are, of course, cases where the premium is higher and others where there is no charge whatsoever for the guarantee. This last case is, however, an exception.

28. The premium is paid either in a single payment based on the total amount of the loan, or annually in respect of the portion guaranteed for the year concerned. Another alternative consists in requiring payment of a partial premium upon the signing of the guarantee contract and then, annually, payment of a reduced premium.

29. The premium rate demanded varies from country to country, but the average annual premium required in developing countries is 1 per cent. It is

essential that the premium level should not discourage either the commercial banks or the borrowers. A problem frequently encountered is that the premium which the guarantee fund should demand, having regard to the risk management costs, legal costs and recovery costs, is so high that it is difficult for the borrower to pay it. In practice, in the majority of cases, the commercial bank passes on the whole cost of the guarantee to the borrower, either directly, or by charging a higher interest rate. This is generally the practice in the countries of central and eastern Europe where the structure of the financial markets is such that the interest rates charged on loans are abnormally high. A guarantee fund whose premium would reflect management costs would therefore exclude a large number of potential users. Here the importance of State financial support can be seen.

D. Claims handling

30. The guarantee contract must obviously define the time of loss. This is generally specified in terms of the number of payments still due. The contract also generally specifies a number of duties that must be performed by the commercial bank in order to effect recovery, such as the sending of reminders in order to secure repayment of the loan.

31. Following indemnification, the question of disputed claims is dealt with by the guarantee fund. It may happen that certain funds are not equipped for this task and they may then delegate this responsibility to the commercial bank. Joint arrangements for dealing with these matters are also a possibility.

32. The efficiency of a guarantee fund is judged by its handling of claims, and particularly by the speed with which claims are settled.

E. Financing of guarantee funds

33. There are various different methods of financing creditor guarantee funds for the benefit of SMEs. The first method is for the State to provide capital for the fund on a one-time basis, no further intervention by the State then being required. Experience shows that, in order to survive, a fund of this nature must apply prohibitive rates that will tend to discourage potential users. Even where this is not the case, the life expectancy of the fund will be limited. A variant consists in seeking State intervention whenever the fund reaches a specified minimum floor. This approach is of course preferable to the first one, as it enables the fund to survive longer and thus to perform its assigned role. A third approach consists in linking the fund's resources to the budget of the State, with the latter undertaking to bear all losses that may arise. The State's participation is not unlimited, of course, and is defined annually. This enables the fund to calculate the magnitude of the commitments it can assume each year. The drawback of this approach is the great dependence on the State. Certain funds, as is the case in Hungary, are budgetarily dependent on an annual vote in the parliament. The funding being with resources derived from privatizations, this increases the financing uncertainty. While this constitutes a novel approach to finding sources of capital, it presents the drawback that any delay in the vote has a direct impact on the operational character of the fund.

34. The extent of the commitments which the fund may assume is, of course, directly dependent on the amount of its capital. As a rule, the maximum level of the fund's commitments is set in its statutes, but in some cases the decision may be left to the discretion of the fund manager. This alternative allows greater flexibility, but it may also prove very dangerous if the manager acts imprudently with regard to the cumulative commitment.

35. In those countries which are more advanced in the area of guarantee fund management, the maximum level of cumulated risk at any given time may be 20 to 25 times the capital. 4/ In certain cases, the multiplier may even be 36. Some funds operate on the basis of a factor of 10. However, there are also funds that operate on the basis of a factor of only 1. Factors of 20 to 25 generally constitute an acceptable approach, since a well-managed fund attains, after a few years of existence, a loss ratio of the order of 3 per cent to 5 per cent.

36. From the standpoint of guarantee fund management strategy, it is advisable for the manager to limit his commitments to 10 or 15 times his capital, increasing them later to 20 or 25 times. This permits a progressive increase in risks as the manager gains experience and is able to exercise better control. This last point is particularly applicable in developing countries, where the manager of a new fund rarely has previous experience of such management.

37. A guarantee fund calls for strict financial management. Even where professionals are concerned, the administrative organs selected for this task rarely possess the technical capability to manage such a fund. In some cases, a management that is lacking in foresight, or is even speculative, may make it difficult for the guarantee fund to perform its task.

38. Guarantee fund management is by no means simple. In theory, the capital of the fund should be drawn on only in the event of a grave financial crisis. The premiums paid by the lending financial institutions should be sufficient to ensure balanced results, through the financial income derived from capital invested. An ideal solution would be to entrust the financial management to a specialized body having the necessary capability. Where this solution is adopted, however, the management body often lacks sufficient autonomy. Nevertheless, over the long term, this form of management will give the guarantee fund a degree of flexibility that should enable it to cope with difficulties.

39. As for the resources of guarantee funds, in addition to the contribution provided by the State where the fund is capitalized, they consist in income from investment of any cash balance and premiums or commissions on the guarantees provided. When recoveries are possible, these of course make a positive contribution to the fund's resources.

40. It should be noted that, as a general rule, guarantee funds are not subject to taxation. Frequently, where such funds are set up as corporate companies, the State allows the fund capital to be increased through incorporation of any profits.

F. Forms of management

41. There are various approaches which may be adopted. One of the most common ones is recourse to a manager. Here the fund has a General Manager who supervises a team responsible for the fund's operations. The General Manager reports to the fund's Board of Directors. The latter represents the fund's shareholders.

42. The principal shareholder of a guarantee fund is generally the State. It is represented on the Board of Directors through the Ministry of Finance. In many cases other ministries represent the State at different levels. The directors quite often include, in addition to officials of the Ministry of Finance, officials of other ministries such as the Ministry of Economic Affairs, the Ministry of Agriculture and others. Also frequently included in the membership of the Board of Directors is a representative of the private banking sector. Some boards also include a representative of the users, i.e. of the SMEs, often through their association, if any.

43. The everyday management of the fund is entrusted to a General Manager who leads a larger or smaller team (depending on the volume of the fund's activities) of specialists in various disciplines. The nucleus of the team is generally composed of credit analysts, specialists in small and medium enterprises and lawyers.

44. Any guarantee fund set up for the benefit of SMEs must be regarded as a genuine economic policy tool of the government concerned.

G. Risk analysis

45. One of the major principles of a guarantee fund's risk management consists in its carrying out risk analysis that is independent of that performed by the banking institution. The guarantee fund obviously does not systematically approve all applications submitted to it. The bank must of course provide a comprehensive dossier on each project, but the fund's analyst has to make a further evaluation on the basis of the fund's own decision-making criteria.

46. There are various formulas for the final decision as to whether or not the guarantee will be provided. Some funds allow the analyst to take, by himself, the decision to grant or deny a guarantee. Often a maximum amount is set, up to which the analyst can take the decision on his own responsibility. Above that limit, co-signing by a second analyst is required or else the dossier must be submitted to a Credit Committee. Some funds take all their decisions in a daily credit committee. In this case the analyst prepares the dossier and submits it to the committee. The latter is often headed by the General Manager and several senior analysts. The decision is often a collegial one, with the General Manager's vote being decisive in the case of a tie. The guarantee fund's statutes may provide for the existence of a Special Credit Committee for major risks. This committee is generally formed of members of the Board of Directors. Recourse to this procedure is exceptional, however, as the size of the guarantees sought by SMEs is generally compatible with day-to-day fund management.

47. Analysis of the dossiers is carried out in an entirely conventional manner on the basis of financial criteria, but also on the basis of the

viability of the projects submitted. Frequently, the financial criteria are insufficient and would lead to systematic rejection of the projects proposed. For this reason, the analyst places emphasis on the quality of the project submitted. This may consist in investment in production facilities for the purpose of expanding present activities or in developing a new range of products. Investment projects are the most frequent type. Moreover, some guarantee funds confine their participation to investment projects while others are prepared to guarantee the financing of a working capital fund. Finally, some will guarantee working capital funds only where the financing is directly linked with an investment operation also covered by a guarantee. This is an acceptable approach from the standpoint of economic logic. In too many cases, SMEs have been granted financing for investment when the operating capital necessary for implementing the investment has not been accorded. However, an approach consisting in guaranteeing the financing of working capital funds only would prove far too risky.

48. The analyst will require a tangible form of security where there is any. Failing this, the mortgaging or pledging of the object financed will be required. As a rule, this tangible counter-guarantee is furnished in favour of the guarantee fund. Under some banking legislation the benefit of the tangible security goes to the financial institution. In this case, the fund must agree with the bank on transfer of the security in its favour.

49. The scope of creditor guarantee funds for the benefit of SMEs is generally limited. In most cases, the statutes of the fund establish a set of eligibility criteria that clearly define the scope of the fund's intervention. The most common criteria are the following:

- the SME must belong to a particular economic sector;
- new jobs must be created;
- the investment must be in a poorer region;
- the investment must be in means of production;
- the project must be in a priority sector (new technology, etc.).

50. All commercial banks do not have access to the guarantee fund's facilities. In many cases they must have signed an agreement with the guarantee fund which sets out the conditions for access. Some guarantee funds have instituted an accreditation system which enables commercial banks to benefit from an automatic guarantee for small loans. Such a facility is never granted upon the establishment of a new fund. It calls for a greater or lesser amount of experience, according to the bank concerned. Only banks which have a record of excellent management of their loan portfolio, as regards the evaluation of credit risks, supervision and recovery, may enjoy accreditation. When this facility is granted it is limited in time and will always be carefully monitored. An accredited bank can have its accreditation withdrawn at any time if the quality of its portfolio management deteriorates. Some funds reduce the guarantee ratio if the loans granted have not had their prior approval. The danger of such a facility is the possible tendency of the bank to make the guarantee fund assume responsibility for the loans involving the greatest risk.

Chapter III

APPLICATION OF CREDITOR INSURANCE

A. Guarantee funds and creditor insurance

51. There have been various projects for comprehensively insuring, through a creditor insurance system, loan guarantee funds for the benefit of SMEs. However, in the developing countries only very few such projects have actually been implemented. The problem is that, from the outset, the banks will make a selection of risks and submit to the guarantee fund only projects for which there is insufficient tangible security. In case of loss, therefore, the remedies available are limited, to say the least.

52. Frequently, criteria for provision of guarantees are not the same as those that are applied by creditor insurers, particularly where the latter are private concerns. These must obviously always seek to ensure balanced financial results. Experience shows, on the other hand, that certain guarantee funds are managed with a lack of professionalism the reason for which is clear: the State will cover any losses.

53. Nevertheless, it is possible to imagine the application of creditor insurance in the case of a guarantee fund, using an approach similar to the "excess of loss" system for covering catastrophic losses that may occur during a given period. The intervention of the insurer occurs only at the end of the period if the accumulated losses during the insurance year exceed a certain ceiling that might endanger the very existence of the fund. Through this system of financial rebuilding, the insurer avoids the need for the State to make a further injection of capital. This formula is recommended and is already applied in industrialized countries. However, the insurers must avoid precipitate action and creditor insurance, where it appears feasible, must be instituted with very great care.

54. It is also possible to envisage the use of such a method by resort to reinsurance, provided the terms and obligations of the reinsurers are clearly defined. Here again, however, where developing countries are concerned, it will be very difficult to find international reinsurers that are prepared to cover such risks, particularly since the latter are of a purely local nature. The situation is different, of course, for the emerging countries of Latin America (Chile, Argentina and Mexico) of Central Europe (Czech Republic, Hungary and Poland) and of Asia (the "Asian Dragons"), and some insurance groups are contemplating playing a role in these regions.

55. Where creditor insurance is applied in the case of a guarantee fund, there are certain dangers which must be avoided. These are sometimes due to the fact that, with the security which the fund represents, a security derived from the support of the State, the commercial banks may be slow in informing the guarantee fund of possible risk of insolvency of beneficiaries. The fund is then sometimes surprised at the extent of the losses for which it belatedly has to provide compensation. Consequently it must impose strict rules concerning the exact time at which any loss must be announced.

56. Another drawback presented by certain guarantee funds is the fact that sums due are not collected with the same celerity and vigour as are applied by creditor insurers.

57. However, the handling of disputes, while preserving a human face, must not neglect possible remedies in cases of chronic default in payment, which is sometimes due to manifest negligence on the part of the beneficiary, or even aggravated fraud. In such cases, the guarantee fund does not always possess the necessary qualifications for this type of work and may entrust it to a creditor insurer. The latter would then be tempted to apply its own methods.

58. For these various reasons, creditor insurance cannot be applied in accordance with its customary norms, unless strict rules are applied to the guarantee fund for recovery of sums for which the insurer has indemnified.

B. Guarantee funds and the European Union

59. The report of the Brussels round table of senior personalities of the European banking sector was submitted to the Commission of the European Union on 19 May 1994. This report outlined possible ways of improving access by SMEs to various sources of financing. It also recommended the following measures: improvement of communication between banks and SMEs; training of bank personnel in order to develop understanding of SMEs; adaptation of the banks' financial products to the needs of SMEs; encouragement by member States of guarantee funds and mutual guaranty companies for the benefit of SMEs.

Chapter IV

DESCRIPTION OF SELECTED GUARANTEE FUNDS

A. Supranational guarantee funds

60. Any study of guarantee funds established for the benefit of SMEs must also refer, even if only in partial fashion, to the existence of regional funds. This applies in particular to the case of the ACP countries (Africa-Caribbean-Pacific) where such funds exist. Only very few of these specialize exclusively in the SME sector, but such enterprises are nevertheless often included in their mandate.

61. The various African guarantee funds operate along comparable lines. There main aims are to promote the economic and social development of the member States and to contribute to regional balance within the community. They have been set up primarily to assist those countries that are most affected economically, either because of their geographical situation or as a result of some economic disaster. 5/

62. Their principal common activity consists in furnishing guarantees for loans granted by other financial institutions, guarantees in respect of both interest and principle. The counter-guarantee of the beneficiary State is often required.

63. Some of these funds combine the function of a guarantee fund with that of a development financing institution inasmuch as they also grant loans for specific projects. These bodies are financially autonomous, their resources being derived from the contributions of member States. However, their resources may also include funds from bilateral, multilateral or other sources, as well as grants and other forms of contribution.

64. Most of them give priority to regional projects and to projects in the least-industrialized States. For most of them, the project must form an integral part of the host country's national objectives.

65. The following are the various funds of this type:

- ECOWAS Fund for Cooperation, Compensation and Development (Lomé, Togo);
- Fonds Africain de Garantie et de Coopération Economique - FAGACE (Cotonou, Benin);
- Mutual Aid and Loan Guarantee Fund of the Entente Council - FEGECE (Abidjan, Côte d'Ivoire);
- Fonds de Solidarité Africain - FSA (Niamey, Niger);
- Solidarity and Intervention Fund for the Development of the West African Economic Community - FOSIDEC (Ouagadougou, Burkina Faso).

B. Geographical listing of creditor guarantee funds for the benefit of SMEs

CENTRAL AND EASTERN EUROPE

Hungary: Hitelgarancia Rt

66. Hitelgarancia Rt was established on 7 December 1992 and has a capital of 3.34 billion forints. Two billion forints were provided by the Hungarian Government and the remainder by 66 financial institutions and 10 professional associations. The purpose of this fund is to encourage the granting of loans to small and medium enterprises through provision of joint guarantees.

67. The fund undertakes to provide guarantees only to:

- enterprises and cooperatives in which private individuals hold the majority share;

- enterprises established for the purpose of implementing the Employee Stock Ownership Programme.

68. The fund furnishes guarantees for commercial banks, specialized financial institutions and savings cooperatives that form part of its shareholders.

69. The fund offers no guarantees in the following cases:

* where the promoter of a project has already applied to the fund for other services or some other guarantee scheme, and has not honoured its commitments over a period of three years;

* where the amount of the joint or several liability exceeds 100 million forints;

* where the promoter has been declared bankrupt or is in liquidation.

70. The maximum amount guaranteed by the fund is 80 per cent of the paid up capital of the debtor + interest + contribution, with the total of these three not exceeding 100 million forints. The interest guaranteed and the contribution may not exceed 40 per cent of the total capital guaranteed and, in this case, the total of the contributions may not exceed 4 per cent of the capital guaranteed.

71. The maximum period for which credit is granted is 15 years. The premium consists of two elements:

* the management costs (minimum amount 20,000 forints);

* an annual premium of 1 per cent to 3 per cent of the amount covered.

Estonia: The Small Business Loan Fund

72. This fund is directly attached to the Ministry of Economic Affairs. It was provided with an initial capital of 1.9 million D.Marks and offers guarantees to commercial banks, in addition to granting loans directly to SMEs.

73. The criterion for access to the fund is the number of employees. This may not exceed 200.

74. The cover ratio of the guarantee may not exceed 75 per cent of the project cost. The projects given priority are those in the following fields: manufacture (new technologies), export, rehabilitation of existing infrastructure, regional development and innovation.

75. The fund operates with an annual budget financed by the Government. It also benefits from financial support from foreign governments and private individuals. It can also carry out long-term borrowing covered by the Government's guarantee.

AFRICA

Cameroon: Fonds d'Aide et de Garantie des Crédits aux Petites et Moyennes Entreprises (FOGAPE)

76. This fund was set up in 1975 for the purpose of guaranteeing loans made by commercial banks or by the Banque Camerounaise de Développement pour les projets d'investissement des PME.

77. The financial resources of FOGAPE are derived from government grants and a tax on the banks' annual profits.

78. The loan cover ratio is set at 80 per cent.

79. Following major abuses in the utilization of loans guaranteed by FOGAPE, the latter was dissolved by the authorities.

Malawi: Small Enterprises Development Organisation of Malawi (SEDOM)

80. SEDOM was founded in 1982 on the initiative of the Government of Malawi. Initially it was a mechanism for the financing of SMEs that submitted economically viable projects. It later introduced a Credit Guarantee Scheme offering cover for up to 80 per cent of the amounts financed either by the National Bank of Malawi or by commercial banks for the acquisition by SMEs of capital goods.

81. A novel feature of this fund is the possibility it enjoys of taking a share in the capital of SMEs. In this case, it acts as a national investment corporation for the benefit of SMEs. Its action is particularly welcome when the SME's capital is insufficient for the execution of a viable project.

Regional: Assurance du Risque des Investissements en Afrique (ARIA)

82. The ARIA fund was established jointly by the French Ministry of Cooperation and the Caisse Centrale de Coopération Economique (CCCE). It is managed by SOFARIS, a French specialist in risk insurance for capital invested in the development of SMEs.

83. The purpose of ARIA is to facilitate the financing of private investment by means of loans. The decision to provide a guarantee is taken by the fund's Management Committee on the basis of a dossier prepared by the lending financial institution and transmitted by the CCCE agency to SOFARIS, which provides the Committee's secretariat and submits guarantee applications to the Committee with its views thereon.

84. Projects for financing must furnish an additional guarantee in that they must be of sufficient viability, involve a limited economic risk and offer to the bank other possibilities of obtaining indemnity guarantees of equivalent reliability.

85. The guarantee is provided for any operation carried out by a private enterprise within the scope of the fund's activities. The only requirement is that it should be a privately managed enterprise in the competitive production sector.

86. The ARIA guarantee fund's characteristics are as follows:

- cover ratio: 40 per cent of the total loan amount;
- intervention floor: 1 million French francs.

87. Loans in excess of 10 million French francs can be covered only in respect of that part of them which is below this ceiling.

88. The fund's commissions are as follows:

- initial contribution: 3 per cent of loan amount;
- annual contribution: 2 per cent of the cover in force.

LATIN AMERICA AND CARIBBEAN

Barbados: Credit Guarantee Scheme for Small Business

89. This guarantee fund is managed directly by the Central Bank of Barbados as part of its Export Credit Insurance and Guarantee Department. The fund was set up in 1979.

90. The purpose of this fund is to enable small enterprises to obtain financing from commercial banks and other credit institutions without having to furnish guarantees of their own. The commercial banks are responsible for evaluation of project proposals and for their submission to the Central Bank. The applications for guarantees are then examined by the Central Bank in order to ensure that the project terms and conditions are met. The bank's

evaluation of the risk is generally accepted automatically by the Central Bank without further research. The commercial banks are required to notify the Central Bank monthly of any loan applications that are rejected.

91. The premium rate applied on loans benefiting from the fund's guarantee is 1 per cent per annum. The settlement is quarterly and is based on the highest level of the guarantee during the quarter concerned. The risk retention by the commercial bank is 20 per cent for periods of up to one year and 30 per cent where the duration of the guarantee exceeds one year. The guarantee covers both the risk of bankruptcy and presumed insolvency of the debtor.

92. We have noted, however, that this guarantee fund's activity is still very limited. Although amendments made in 1991 to the system of operation of the fund have made it more attractive for SMEs and commercial banks, there has been no major change in its use.

Mexico: Banco Nacional de Comercio Exterior (Bancomext)

93. Bancomext is the Mexican governmental agency responsible for promoting Mexico's foreign trade. Various action programmes have been developed for this purpose in the areas of financing, insurance and guarantees. In particular, a programme of guarantees for loans made by commercial banks or credit unions to SMEs engaged in export has been developed.

94. The cover offered by Bancomext is 70 per cent of the amount of the loan in the case of commercial banks and 50 per cent in the case of credit unions. The cover offered by Bancomext is generally automatic and is provided without any prior evaluation.

Peru: *Fondo de Garantía para Préstamos a la Pequeña Industria (FOGAPI)

95. The foundation FOGAPI is a non-profit making association founded in 1980 and financed by contributions from the Sociedad Nacional de Industria (SNI), the Asociación de Pequeños y Medianos Industriales del Perú (APEMIPE), the Servicio Nacional de Adiestramiento en Trabajo Industrial (SENATI), the Ministry of Industry, Foreign Trade, Tourism and Integration (MICTI) and the Corporación Financiera de Desarrollo (COFIDE). Its purpose is to promote the development of small enterprises by providing guarantees for the banking system.

96. Since its establishment, FOGAPI has concluded a series of trust agreements with COFIDE; the latest of these was renewed in August 1994.

97. This fund's method of operation is to issue guarantees for the benefit of commercial banks and the suppliers and buyers of small enterprises, being aided in this by counter-guarantees consisting of pledges and mortgages on movable and immovable property.

98. Since it commenced operations, FOGAPI has succeeded in having its guarantees accepted by the financial institutions. It can guarantee up to 50 per cent of the amount of a loan granted by a financial institution. If the loan is a short-term one not exceeding $5,000, FOGAPI's cover is

80 per cent. For suppliers and clients, the cover provided may amount to 100 per cent. The maximum guarantee amount is $30,000 for loans and suppliers and $40,000 for advances and tenders.

99. As at 30 June 1994 FOGAPI had assets totalling $530,000 made up of contributions by the Government of the Netherlands and MICTI.

100. With the aim of obtaining greater guarantee cover and decentralizing decision-making, FOGAPI has in recent months made efforts that have led to the establishment throughout the country of regional executive committees in which NGOs participate.

*<u>Sociedad de Garantías para Préstamos para la Micro y Pequeña Industria (SOGAMPI)</u>

101. The fund SOGAMPI is also a non-profit making association, founded in January 1992, whose principal purpose is, through the provision of guarantees, to assist SMEs in obtaining loans.

102. Under its statutes, SOGAMPI can grant loans directly, provide guarantees and furnish advisory services in the area of project financing.

103. SOGAMPI can provide guarantees of up to 100 per cent for financial institutions and suppliers, but in practice the percentage is only 50 per cent in the case of loans and 80 per cent for trade credit. In the two cases, the total amount of the guarantee may not exceed $35,000.

<u>Ecuador</u>: <u>Fondo para la Pequeña Industria y la Artesania (FOPINAR)</u>

104. The purpose of FOPINAR is to assist in the establishment of small industries and handicraft concerns and to make possible the expansion and modernization of existing plant through provision of loans and guarantees. The fund also offers facilities for supporting entrepreneurs through provision of technical assistance.

105. The fund is particularly oriented towards small processing industries, handicraft and artistic goods production, small-scale fisheries, tourism and specific support services for manufacturing. It can also provide financing for service microenterprises in specific sectors.

106. The fund furnishes guarantees to credit institutions for up to 75 per cent of the total amount of the loan in the case of a newly-established enterprise (for a specific project), or up to 85 per cent of the amount of the loan in the case of projects for expansion or modernization in an existing enterprise. The guarantee is furnished to private individuals or bodies corporate possessing fixed assets, not including land and buildings, that do not exceed a specified value.

107. FOPINAR also finances the acquisition of fixed assets (machinery and equipment), construction and initial working capital needed for projects. Land and vehicles are not included. The fund also offers credit to cover the costs of technical assistance.

Summary table of guarantee funds (Asia, America and Europe)

The following table shows the principle features of the main guarantee funds throughout the world.

	GERMANY	BOLIVIA	COLOMBIA	REPUBLIC OF KOREA	COSTA RICA	CHINA	ECUADOR	EL SALVADOR	SPAIN
ORIGIN	State	State	State	Law	Private	State	State	State	*Commercial corporations *State
TYPE	Private guarantee association	Guarantee fund	*National Guarantee Fund *Foundation	Guarantee fund	FUNDES	NGO guarantee fund	Private-law entity	Guarantee fund	Mutual guarantee association
RESOURCES	*Commissions *Local subsidy *Central government	AID support	*Bilateral cooperation Spain and Germany *Cooperative *Bank	*Commissions *Taxes on banks	*Commissions *Transfers	*Central government *Local governments *Financial institutions *Commissions	Central Bank	*Central Bank *AID support	Government (central and regional) Corporations
BENEFICIARIES	Small enterprises	Small enterprises	Micro-, small and medium enterprises	Small and medium industries	Small and medium enterprises	Small and medium enterprises	Small and micro-enterprises	Small and micro-enterprises	Small and medium enterprises
COMMISSIONS	1% per annum		2%-3%	1%		0.5% per annum	4%	4%	2.5%-3% per annum
IRRECOVERABLES RATIO			4%	/	Almost 0%	1%	2%		5%-20%
RESULTS	Does not cover costs			Negative: Charges > costs	Liabilities of US$ 200 000	Positive			
SECURITY	Association's evaluation			Fund's evaluation	Strict evaluation	Fund's evaluation		Fund's evaluation	Company's evaluation
COVER RATIO	75%	50%	80%	80%	50%	90%	65%	70%	100%

Summary table of guarantee funds (Asia, America and Europe) (continued)

	GERMANY	BOLIVIA	COLOMBIA	REPUBLIC OF KOREA	COSTA RICA	CHINA	ECUADOR	EL SALVADOR	SPAIN
ADDITIONAL PROGRAMMES				*Loan guarantee *Information *Technical assistance	*Advice *Training *Guidance	*Credit information *Technical assistance *Foreign trade	*Technical assistance	*Technical assistance	*Technical assistance
CAPITAL MULTIPLIER				7 x capital	Up to 3 months	5 x capital			
PORTFOLIO			US$ 23 million	US$ 2.3 billion	US$ 300 000	US$ 5.439 billion	US$ 700,000	US$ 24 million	
INFRASTRUCTURE	4 Guarantee associations		8 Offices	1 300 employees 24 branches		Banks: 44, with 1 500 branches			20 companies

Sources: Various studies by IDB, LAIA, European Union, etc.

Summary table of guarantee funds (continued)

	UNITED STATES	HONDURAS	NETHERLANDS	HUNGARY	ITALY	JAPAN	MEXICO	UNITED KINGDOM	VENEZUELA
ORIGIN		State	State	*Government *Financial inst. *Corporations	Heads of enterprises	Legislation	State	State	State
TYPE		Guarantee fund	Account	Credit corporations guarantees	*Association *Cooperatives *Consortium of enterprises	Guarantee corporations		Guarantee scheme	*Corporations *National mutual guarantee corporation
RESOURCES		AID	Budget	*Government *Commissions	*Banks *Institutions *Commissions	*Commissions *Contributions	Guarantee scheme	Commissions	Corporations
BENEFICIARIES	Small enterprises	Small and micro enterprises			Small enterprises		Small and medium enterprises		Small and medium enterprises
COMMISSIONS		5% per annum	0%	3%	1.5%	1% per annum	0.5%-3.5%	3.4% per annum	1%-5%
IRRECOVERABLES RATIO	13%							20%	
RESULTS	Does not cover costs					Costs: 2%		Negative	
SECURITY				Fund's evaluation		Corporation's evaluation	Fund's evaluation		Fund's evaluation
COVER RATIO	90%	70%	100% of risk	80%		100%	50%	70%-80%	80%

Summary table of guarantee funds (continued)

	UNITED STATES	HONDURAS	NETHERLANDS	HUNGARY	ITALY	JAPAN	MEXICO	UNITED KINGDOM	VENEZUELA
ADDITIONAL PROGRAMMES				*Technical assistance support	Financial and bank assistance		*Technical assistance *Financial assistance		
MULTIPLIER				2 X Capital					20 X Capital
PORTFOLIO	US$ 7.1 billion	US$ 5.4 million				US$ 500 million		UK£ 530 million	
INFRASTRUCTURE	*2 000 officials *11 regional offices			8 associations 35 persons	885	52 corporations		Minimum 3 persons	

Sources: Various studies by IDB, LAIA, European Union, etc.

Chapter V

PRINCIPAL OBSERVATIONS CONCERNING GUARANTEE FUNDS

108. It is often difficult to propose a guarantee fund model that will have a sufficiently broad spectrum of application. Furthermore, a model always tends to be a reduction of the reality it is supposed to represent. Consequently it would be dangerous to seek to apply a universal model without first making certain adjustments.

109. Each guarantee fund has its raison d'être in the environment within which it has to operate. Its form of organization and method of functioning must therefore meet the requirements expressed locally by SMEs.

110. As we saw earlier, it is not possible to conceive of a guarantee fund without central government support, but the participation of the banking sector is just as essential for the success of the operation.

111. In some countries, the private sector, and particularly the banks, lack confidence in the State. In such cases, the banks always maintain some distance from a fund that will be under State control. Some States are deemed insolvent by their banking sector. This lack of confidence in the State naturally nullifies the usefulness of such a fund, whose guarantee will be deemed of no value. In such cases, the financial contribution made by one of the main international institutions will often serve to give the fund credibility. Here we enter into the question of the solvency of guarantee funds. If the fund is managed by the State and the latter is deemed solvent no problem will arise. On the other hand, as we have seen, if the State is deemed insolvent no one will regard the fund concerned as in any way credible. It is therefore essential, in countries where the credibility of the State presents a problem, to have the continuing support of an international or credible guarantor who will furnish capital and fund management know-how.

112. In every case the State will have to use the fund as an economic policy tool.

113. It will also generally be desirable for the fund to be autonomous. The juridical status of a non-profit making enterprise is a form of organization that suits these funds particularly well. Should any profits be made, they will serve to increase the capital and thus to expand the services offered.

114. The principle of risk-sharing between the banker and the fund is essential for the fund's success and only rare exceptions should be made to this rule. The premium charged should as far as possible reflect real costs. Here too, it will be necessary to determine who is to pay the final premium: the banker or the SME. Account must be taken of the reality of the marketplace and, in particular, of the interest rates practised by the banks. The cost must in any event remain reasonable for the borrower. Failing this, the fund will have failed to attain its objective. This does not necessarily mean that the fund must be subsidized, but rather that there is a need to correct distorting effects which may exist in particular money markets.

115. It is impossible to over-emphasize the importance of independence of decision-making; the fund must have the final say in approving or disapproving a given guarantee. A guarantee must be provided only for the most promising projects and others must imperatively be rejected.

116. It is also necessary to warn against a fourfold danger that often threatens guarantee funds:

- insufficiently professional risk selection;

- lack of firmness by commercial banks in announcing payments overdue;

- inadequacy in the handling of disputes;

- passivity or even laxity in the management of resources.

117. A point that must not be forgotten is the need for the personnel of such a fund to show professionalism and a knowledge of the techniques of credit and guarantee transactions, as well as of the special economic and financial characteristics of small and medium enterprises.

Notes

1/ Caisse Nationale de Crédit Professionnel, Rapport Annuel 1992, p. 20, Belgium.

2/ World Bank Lending for Small and Medium Enterprises, 15 years of experience, Leila Webster, December 1989.

3/ Microenterprise and the IDB, Credit where it's due, Inter-American Development Bank, Washington.

4/ Credit Guarantee Schemes for Small and Medium Enterprises, Jacobs Levitski and Ranga N. Prasad, World Bank, 1989.

5/ Centre for the Development of Industry (ACP - EC), Ressources Financières pour les Projets Industriels dans les Pay ACP, November 1993.
