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SMEs' Credit Guarantee Schemes in Developing and Emerging Economies

Reflections, Setting-up Principles, Quality Standards

Published by

giz Deutsche Gesellschaft
für Internationale
Zusammenarbeit (GIZ) GmbH

Table of contents

Abstract	4
The authors	5
Preface	6
1 Why guarantee schemes?	8
1.1 Financial constraints of SMEs and micro-enterprises in Developing Economies	8
1.2 Usefulness of guarantee schemes	11
1.3 Types of guarantee schemes	13
1.4 The nature of guarantee schemes	14
2 Quality standards for guarantee schemes	16
2.1 Risk partnership with banking or micro-finance institutions	16
2.2 Integration into the financial sector	21
2.3 A professional analysis of guarantee applications, for only viable projects	26
2.4 A rigorous risk management	30
2.5 Strict limitation of risks in the agricultural sector	46
2.6 Suitable guarantee fees	49
2.7 Shareholders that really want to succeed	52
2.8 Conservative financial investments, cash management	55
2.9 Effective monitoring, restructuring and default management procedures	58
2.10 Performance indicators: sustainability, additionality	61
2.11 Subsidiary and strictly limited government support	63
3 Create a sustainable guarantee company: Methodology	70
3.1 Exploring the environment	72
3.2 Basic options	77
3.3 Size and solvency of the company	87
3.4 The founding of the company	96
3.5 Implementing management policies	111
4 Conclusions	127
Annexes	130
Annex 1 – Liste of abbreviations	130
Annex 2 – Financial terminology	131
Annex 3 – Bibliography	134

Foreword

SME Credit Guarantee Funds – revisiting a tried-and-tested tool

The economic and social importance of small and medium sized enterprises (SMEs) is beyond dispute. In most of our partner countries they contribute up to 50 % of GDP and employ about 40 % of the labour force. The existence of a strong SME sector is not only an important factor for balanced economic growth, but also for social and political stability. However, SMEs often have inadequate access to financial services, limiting their growth and investment opportunities.

SME finance also has an important place in the development agenda of the G20. Germany is known for its strong SME sector with its enormous innovation potential and productivity, and one important success factor for the sector has undoubtedly been its access to finance. Germany, through the Ministry for Economic Cooperation and Development (BMZ), co-chairs the SME Finance Sub-Group with the United States, the United Kingdom and Turkey, and also leads activities in the Work Stream on Agricultural Finance for SMEs, a field that still poses enormous challenges for our partner countries. German Development Cooperation through Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) GmbH and KfW Entwicklungsbank (KfW) is implementing a large number of project supporting access to financial services for SMEs.

Experience shows that when dealing with SME finance in our partner countries, there are not many alternatives to (partial) guarantee mechanisms as long as viable projects cannot obtain funding and jobs fail to be created solely because collateral is lacking. A credit guarantee scheme, however, should not be seen as an invitation to finance indiscriminate spending on credit. Its main concern should be to distinguish between viable and unsustainable credit projects and to avoid misuse for purposes other than the original intention – giving viable entrepreneurial projects a chance. Despite their problematic nature as an incentive, credit guarantee schemes are in demand in our partner countries and should not be left aside as an instrument. This demands a well developed incentive and sanctions structure, sound independent management and close contact with market actors.

In this manual we are not seeking to re-invent the wheel but aim instead to provide clear guidance on how to set up and run a credit guarantee scheme, in the light of both positive and negative experience from the past. Our three authors have looked in depth at this topical issue to help readers find their way through the maze of good and bad practice. They offer hands-on advice for all those implementing and managing credit guarantee mechanisms in development country contexts.

I wish you happy reading and successful implementation of your credit guarantee scheme.



Roland Gross

Head of Sector Project on Financial Systems Development,
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Abstract

Practitioners in private sector development in developing countries often deplore that small and medium-sized enterprises face major difficulties in mobilizing external capital, above all loans from banks, due to **lack of bankable collateral**. Micro-enterprises appear to be better off because microfinance institutions have developed loan technologies that depend less on collateral, yet microfinance institutions frequently face refinancing constraints due to lack of collateral on their part.

The collateral constraint to the extension of credits is aggravated in times of crises by the **decrease in value of bankable collaterals** (like real estate/mortgages, certain accounts receivable, securities and other assets).

In many countries – developing and industrialized – guarantee facilities have been set up on government, NGO or private initiative in order to mitigate the collateral constraint of small & medium-sized enterprises and microfinance institutions. These guarantee facilities have however frequently incurred losses, in some cases even heavily. A certain disillusionment has therefore set in.

This manual argues that guarantee facilities can nevertheless be a useful instrument to promote SMME's¹ finance – directly and indirectly through microfinance institutions' refinance – if certain **strict standards** are observed (see chapter 2). Against the backdrop of increasing food prices the risk management framework proposed in chapter 2 also takes into account the (limited) possibilities to extend guarantees to the agricultural sector. Furthermore, chapter 2 sets out **guidelines for a reasonable public sector involvement** that strictly limits risks for public budgets and avoids distortions of competition.

A further chapter gives detailed practical advice to promoters wishing to **create a sustainable guarantee facility** (chapter 3).

This manual does not deal with guarantees destined to stabilize monetary markets nor credits to facilitate the finance of infrastructure².

1 small (including micro-) and medium-sized enterprises

2 for this see WINPENNY, James (2005)

The authors

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Preface

The academic world considers guarantee funds with a somewhat dubitative opinion, retaining above all some rather disappointing experiences. Recent publications concluded:

- “In a strictly economic sense, most of the guarantee mechanisms seem to have failed in the past three decades”³.
- “Today, more than 2,250 credit guarantee schemes exist in a large variety of forms in nearly 100 countries but most are small, local, weak and of faltering sustainability”⁴
- “To date, no SME and micro borrower guarantee company has consistently priced guarantees at levels that permit it to maintain its capital ... losses often are offset either by donor funds or continuing subsidies ... SMEs and micro lenders do not require guarantees but instead a different loan appraisal and loan supervision technology that is substantially different from the norms of commercial banking”⁵.
- “... creation of guarantee funds to ensure refund in case of default. In several countries, especially in Central Africa, this has not worked since provision of a guarantee has meant less rigorous choice of investment projects and a lower rate of debt recovery.”⁶

In 1986, a conference established that “the explicit purpose of a credit guarantee scheme/credit guarantee fund to induce banks to increase their lending to small businesses can only be fulfilled if it is permanent subsidized, since most of them decapitalize rapidly”⁷.

At a 2008 World Bank conference, a professor argued that “guarantee companies have this in common with Bank deposit insurance, that they create concealed additional losses by a form of “subsidy”⁸.

Often disappointing experiences of the past are not however, according to the authors of this manual, a sufficient reason to give up efforts to find effective solutions to the problems of **lack of credit collaterals** (like pledges and guarantees) **which is one of the most serious bottlenecks that limit the financing of SMMEs**⁹ in developing and industrialised economies (this aspect will be discussed in more detail in chapter 1). Micro-enterprises are indirectly affected by this constraint in that micro finance institutions face refinancing problems due to lack of collaterals on their part.

Lack of collateral plays even stronger in times of economic crises to the extent that typical crises give rise to a loss in the value of goods that may be used as credit collaterals (like real estate or business assets).

Against this backdrop, the authors recommend that a new look be taken with regard to the credit guarantee instrument because a very wide experience has now been accumulated allowing to draw lessons and make a significant contribution to the finance of SMEs and – indirectly, through micro-finance institutions – micro-enterprises.

The condition is to follow a **rigorous approach** at all levels in making up such instruments. The rigour is imperative particularly since international experience has shown that it is difficult to set up profitable guarantee companies.

The rigorous approach also extends to possible support by the public sector. In response to the **reproach of the public sector financial drain** that allegedly accompanies the effects of a guarantee scheme, this manual reacts with another approach, strictly limiting potential support by the government.

3 GTZ, Prepared for the 21st Century, Financial Systems Development and Banking Services

4 from: Ian Davies (2007), p. 32

5 from: Gudger (1998), p. 8, 10

6 Kauffmann (2005), p. 2

7 from: GTZ (1986), p. 67

8 Professor C. Calomiris, Columbia University, Conclusions of a seminar organized by the World Bank, Rensselaer Polytechnic Institute and the Journal of financial stability, The World Bank Washington DC, 13-14/03/ 2008

9 small (including micro-) and medium-sized enterprises

In the range of instruments available to promote the financing of SMMEs, guarantee schemes present an interesting profile in that they fit into the existing financial fabric, without generating competition with institutions on the ground. If they succeed in generating a multiplier effect through which they can support a portfolio of guarantees higher than their equity, then they bring an **“additionality”** at the overall level (more added value into the economy) and at the individual level (**support for projects which, otherwise, would not see the light of day**).

The rigorous approach defended here is limited to loan guarantees for SMMEs and micro-finance institutions¹⁰. Finally, since this preface begins with criticisms of guarantee companies, we would also like to point out positive comments that they have been able to inspire in literature and international conferences:

- “Loan guarantees can enable micro-finance institutions to get loans that are otherwise unavailable to them ... In some cases, the loan guarantees did open the door to subsequent lending [without guarantees]”¹¹
- A study¹² on **Italian** mutual guarantee consortia based on an econometric analysis indicates that the relevance of Italy’s state-funded guarantee scheme for small and medium-sized enterprises “in widening SME access to bank credit is confirmed by our tests ... The empirical evidence presented in this analysis shows that Italy’s scheme has reached a measure of effectiveness in reducing SMEs’ borrowing cost and easing their financial constraints ... The evidence indicates that a high degree of selectivity was used in choosing the targeted SME groups, the individual beneficiaries and the guarantee coverage ratios ... contrary to other SGS [state-funded guarantee scheme] the Italian one has

managed to limit default rates and to contain the public subsidy element, that is required to maintain the Fund’s financial sustainability”.



10 For guarantees in the service of infrastructure projects cf. Winpenny (2005)

11 Flaming/CGAP (2007), p. 1 and p. 9

12 Zecchini & Ventura (2008), p. 20 and 21

1. Why guarantee schemes?

1.1 The financial constraints of SMEs and micro-enterprises in emerging and developing economies

Both for their creation and growth, small and medium-sized enterprises, but also many microenterprises, need financing suitable for each life phase:

- The “working capital” needed to bridge the gap between payment of supplies and intermediary services on one hand, and revenues on the other hand,
- access to credit lines for liquidity facility during ‘peak’ period,
- long term funding is needed for financing investments.

Example:

A small Indian company manufacturing electronic components is actively growing. A new order causes an immediate need of additional working capital of 60 M rupees and, soon, capital investments in equipment worth 240 M rupees.

A new shareholder offers 80 M rupees but the bank is reluctant to make up for the difference as the assignment of receivables and additional pledge of equipment are not acceptable collaterals for the bank because of the very cyclical nature of the electronics industry and the specificity of the hardware. The supplier of these inputs is demanding cash payment.

Entrepreneurs’ equity is often not sufficient, even if it is extended by funds raised in the family or from close relations. A first external source of funding would be supplier credit which defers the payment of a commercial debt. But small entrepreneurs usually have little ability to negotiate payment terms.

Another important source of credit in developing countries (DC) is the informal lender. But he is expensive ... A credit of 100 which will be repaid two months later for an amount of 120 carries an implicit annual interest rate of 198.6 %. Such interest rates render many economic activities non-viable, even in countries with a high inflation rate.

So there remain financial institutions like banks, leasing companies and micro-finance institutions.

a) Banks:

Banks are often put off by the cost of analysing and monitoring insignificant operations. Generally, they do not have complete and updated information on the company’s progress and they dread information asymmetry: the difference between what it knows about the proposed project and what the entrepreneur wants to do with it to make timely refund of the loan.

A means used by banks to better detect risks concealed by borrowers is the requirement of collaterals. By this requirement, banks hope to deter “bad borrowers” with projects containing hidden high risks. Besides, of course, collaterals reduce bank losses in case of suspension or termination of the borrower’s payments¹³.

Moreover, in several countries, banks are subject to rules that require them to demand collaterals as condition for granting credit. “In many countries, bank regulations limit the percentage of the portfolio that may be extended as non-secured loans. The types of security available from microentrepreneur clients, such as solidarity group lending and chattel mortgage on personal assets, are not usually recognized ... For example, in Bolivia, the Law on Banking establishes that the unsecured portion of the portfolio may not exceed twice the equity of the institution”¹⁴. Financial Private Development Organisations in Honduras may grant loans of up to 2 % of equity capital if secured by collateral. In Ghana, rural banks can lend up to a limit of 25 % of their capital in the case of secured loans, and up to 10 % in the case of unsecured loans¹⁵.

Moreover, competition among banks is sometimes low. Bank operators can then make a very rigorous skimming of the loan projects they receive. As an exception, some banks compromise on collateral: “Some institutions are willing to substitute personal equity and other indicators of strong motivation, as well as experience and a willingness to learn new technical and managerial skills, for tangible collaterals”¹⁶. These cases, however, present credit quality above the normal.

b) Leasing Companies:

Unlike banks, leasing companies retain ownership of objects they fund, which gives them a privileged position in case of insolvency of the lessee (separation of the object from the insolvency estate). However, leasing depends on several framework conditions and the possibility to resell property recovered to other lessees, which implies fungible property, equipment, often quite standard. Therefore, leasing is not very common in certain countries¹⁷.

Leasing Companies may also request additional collaterals, if it appears doubtful to recover the leased property in case of failure of the lessee. Working capital which accompanies investment is not offered by leasing companies.

c) Microfinance companies or institutions:

Microfinance institutions (MFIs) are, in many countries, subject to less restrictive rules than banks. Most often they recognize joint guarantees and movable collateral as valid securities.

But they frequently face difficulties of refinancing and collection of addition funding such that, often, they can only offer credits of limited amount and of short duration. MFIs do not often have the same access to capital markets or interbank lending like banks! But if microfinance institutions approach banks for funds the latter normally require “bankable” securities. **Consequently, MFIs, as borrowers wishing to refinance, are liable to face, in principle, the same challenge of providing collaterals as individuals.**

14 from: Berenbach and Churchill (1997), p. 40

15 from: GTZ Eschborn (2003), p. 19. Other examples:

- In Germany, the Supreme Court condemned the Director of a Cooperative Bank to pay damages to his bank for granting credit, which defaulted, “without the usual collateral” (Bundesgerichtshof/ German Federal Court, decision of 21 March 2005– II ZR 54/03 (see also ZIP magazine 22/ 2005, p. 981 s.).
- In Argentina, the Bank supervision uses a risk factor of credits granted according to collateral obtained, to calculate minimum equity required.
- “in most cases regulators will recognize an MFI’s real estate but not its loan portfolio as qualifying collateral” CGAP (2007), p. 7

16 from: Aryeety et al (1994), page 39

17 See for example GÖTTLICH (2002), Leasing Operations in Cameroon and Chad, GTZ

Therefore, the constraint of missing collateral functions in two respects:

- On the one hand, this constraint limits¹⁸ the granting of loans by banks to SMEs and microenterprises¹⁹
- On the other hand, MFIs, although financial companies, are also limited in their access to refinancing. Therefore, financing of MFI customers, which are often small and microenterprises, faces the same constraints.

As a result of the collateral constraint, access to credit is made difficult, if not impossible, for many small businesses, **leaving viable projects unfunded.**

This acute problem in developing countries and emerging economies is exacerbated in rural areas for tenant farmers, that is to say small farmers who are not owners of the cultivated land and whose work often has similar characteristics to that of entrepreneurs²⁰.

Generally, shortage of collateral and inadequate capital are the consequences of a highly **unequal distribution of wealth** and capital in the society, wealth and capital most often not being in the hands of small-sized potential entrepreneurs.

Further examples for difficulties with traditional collaterals:

- The borrower cannot prove his ownership of a property²¹ to be used as collateral due to lack of land registry. Similarly, the lender cannot register his

priority with regard to other lenders over a property used as collateral when mortgage or chattel registers are inexistent, incomplete or uncertain.

- The precariousness of tenant farmers is associated with legal uncertainty. For example, in Laos, “rural commercial banks award credit against land upon which permanent tenure rights according to autochthonous law in Laos exist. The credit costs, however, increase due to the substantial expenses involved in securing the credit when the status of the property must first be proven ...”²².
- A predominance of the State over landed property²³ and the prohibition to lease plots of land to businesses can exacerbate the difficulties.
- Procedures arranging appropriation or the legal sale of property pledged as collateral and confiscated following failure of debtors are not safe.
- The functioning of the courts can raise questions about too long periods for judging and allowing recovery, by lack of transparency and of legal security of the procedures.
- The secondary property market is insufficiently organized and deep for the realizable value of a confiscated asset to be accurately assessed and for effective resale to be done to the satisfaction of the “forced seller”.

18 The constraint of collateral is not the only factor that limits the grant of credits by banks to small businesses ; a other factor is the high cost of granting credits to SME in relation to the small volume of credit

19 an exception is found in India where commercial banks are obliged to reserve a quota (4 % in 2007) of their loans portfolios for economically weak sections of the population, see for example ISERN et al. (2007)

20 “in Uzbekistan, ... tenants are discriminated in view of credits granted. In [Laos], rural commercial banks award credit against land upon which permanent tenure rights according to autochthonous law ... exist. The credit costs however increase due to the substantial expenses involved in securing the credit when the status of the property must first be proven ...” from: GTZ (1998), p. 113

21 “farmers and especially poor rural women have difficulties in clearly demonstrating their legal ownership of assets” from: Klein et al. (FAO/GTZ 1999), p. 12, also p. 15 s.

22 from: GTZ 1998, page 113

23 cf. GTZ (1998), p. 25: “... the majority of the population pushing for entrepreneurial opportunities has limited possibilities for obtaining credit and being granted a loan based on land. This limitation is due to land not being registered ...”, the land being non-transferable in some countries as it is state property

1.2 Of what use can guarantee schemes be?

Guarantee schemes have the social function and economic role to promote access to more credit and/ or a better credit to micro-entrepreneurs and SMEs by providing substitute collaterals, which are complementary to theirs.

In doing so, they can overcome various obstacles to bring credit to **viable but non bankable projects**, due to lack of collaterals or to information asymmetry.

Placed as interfaces between applicants and credit providers, they will render service to both of them.

How can this be done in practice?

An example among others ...

The Kredi Garanti Fonu (KGF) of Turkey provides guarantees to small and medium-sized enterprises (SMEs) up to 250 employees when they lack collaterals to access bank loans or lease financing.

If a businessman or businesswoman applies for credit from a bank and it is likely that the application will be rejected due to lack of collateral, the bank can contact the KGF. The latter takes a quick decision especially according to the following criteria: (1) viability of the enterprise, (2) acceptable project risk, (3) competent management and (4) respect for the environment.

In case of positive decision by the KGF, KGF's guarantee functions as a substitute security; the bank loan is protected up to 80 %.

The borrower pays an annual fee of 1 – 2 % to the KGF, according to the type of guarantee.

KGF guarantees cover particularly:

- Investment loans,
- Working capital loans,
- Business start-up loans,
- Lease operations,
- “Technical” guarantees/bonds that entrepreneurs have to provide in some sectors, for example performance bonds.

KGF signed 32 outline agreements with credit institutions and lease companies.

KGF was created in 1991. Its legal form is a private limited Company. Its shareholding is made up of:

- KOSGEB: Small and Medium Industry Development Organization: 33.2 %
- TOBB: The Union of Chambers of Commerce and Industry: 33.2 %
- TESK, Confederation of Tradesmen and Craftsmen: remainder
- The German Technical Cooperation Society (GTZ, now GIZ) had made a risk fund contribution.

KGF is backed by a national counter guarantee (limited to loans with government subsidies) and a counter-guarantee of the European Investment Fund (50 % loss for investment loans of over 3 year's maturity) and a tax exemption (including income tax).

KGF plays an active role to assist particularly investment projects that may not be funded due to lack of bankable collaterals. A few statistics help to illustrate it:

- Guarantees granted in 2009: € 287 millions
- Number of new guarantees granted in 2009: 1599
- Guarantees granted from 1.1.1994 to 31. 12. 2009: € 553 millions for 4401 projects
- Sectors served: services (15 %), industry (87 %), agriculture and mines (3 %).
- Net average rate of default: approximately 2 to 2.5 %.

Guarantee schemes may make the entire financial sector more efficient.

Here are three reasons:

Reduction of the overall risk in an economy

Guarantee schemes can contribute to the reduction of “specific” risks in an economy. Financial theory proposes to break down credit risks into risks that can be diversified (“specific risks”), and risks that cannot be diversified.

Risk diversification may result in the decrease of total risk. For example, if a bank has two customers each contracting credits (for example an airline and a railway company), it is possible that the total or combined default risk be lower than the sum of the single risks (the reasoning is based on the substitution of means of transport: if the airline is less successful, the use of trains could increase). **Therefore, the sum of risks is not fixed but can be reduced according to the diversification of the portfolio**²⁴. So, if guarantee schemes help in diversifying risks in an economy, they contribute to reducing total risks²⁵.

Reducing adverse effects of financial crises

Financial crises – like the one of the years 2007 – 2009 in Europe and North America – include massive devaluations of collateral²⁶ in the entire economy such that granting credits becomes more risky. The existence of guarantee schemes can mitigate the impact of such crises on SME financing.

Mitigating an inefficient distribution of wealth

The preceding chapter explained why credit institutions often require collaterals. However, this requirement is difficult to be met by the low-off even if they have viable business projects.

Guarantee schemes can offset the adverse effects of this non-match between entrepreneurship and ownership of assets to be devoted to the project or given as collateral to lenders. First, by their very nature, but also in their decision-making mechanisms by the weight they give to the qualitative aspects of applications: training, experience, sponsor’s motivation, economic value of the project.

Compensation for lack of competition among banks

In many countries (not just developing countries, but particularly in DCs), competition among banks is not strong. Therefore, banks do not have much interest in looking for new customers, for example SMEs (with a few exceptions like cherry-picking). Now public authorities are often reluctant to introduce appropriate measures to increase competition among banks for fear of instability in the banking system.

Without in any case trying to justify this reluctance of the authorities to allow competition in the financial sector, the interest of banks to finance SMEs can be increased by the use of guarantee mechanisms.

24 For a good explanation see for example Gérard Charreaux (several editions), chapter “Choix des investissements en situation d’incertitude”

25 cf. for example Suhlrie (2006), p. 717

26 See for example Goodfriend, M. et McCallum B. (2007), p. 1503

1.3 Types of guarantee schemes

Their models are very diversified due to the historical circumstances of their creation and the different legal contexts but also to:

- the scope of their activity
- the distribution channel of the guarantee
- the nature of the entity.

The scope of the activity

It classifies systems that practice “intermediate” guarantee (or “wholesale”), “individual” (or “retail”) or portfolio guarantee.

1. The guarantee “**retailers**” are oriented directly towards SMMEs borrowing from banks or other financial institutions. The guarantee is granted on case by case basis. This very common system ensures control of conditions under which the lender and the borrower enter into a relationship for a given project. It aims to contain the rate of loss to a level acceptable to the guarantor. This system is not suitable for microenterprise in developing countries because the intermediation cost is too high.
2. The guarantee “**wholesalers**” offer their guarantee for the funding of a non bank financial institution, for example a microfinance institution that is interested in financing small businesses. The guarantee facilitates the “refinancing” of these financial institutions by commercial banks.

The Fonds International de Garantie (FIG) in Geneva is a specialist in guarantee refinancing of MFIs. The FIG is a non profit guarantee cooperative based in Geneva, created in 1996 by European, South American and African organizations. Its mission is to support MFIs and agricultural cooperatives in developing countries to obtain loans in local currency from local commercial banks. By supplying bank guarantees to MFIs, the FIG increases financial resources available for small entrepreneurs. Since its inauguration, the FIG has collaborated closely with 53 MFIs and agricultural cooperatives in 17 countries in South America and Africa, thus participating in creating more than 270,000 jobs.

Likewise, the Belgian International Solidarity organization, SOS Faim, created a guarantee Fund for Latin America (FOGAL²⁷) to facilitate the access of producers’ organizations to the banking sector.

3. **Portfolio guarantee** is used for the automatic coverage of a preset volume of loans agreed by a lender to his clients, subject to abiding by a set of criteria imposed by the guarantor (example: the size of the loans, their purpose, and the minimal financial structure of the borrower ...). The guarantor invites tenders from lenders and distributes the coverage available, without participating in the individual decision making.

He receives ex post information on the operations and he is required to share in the loss if the borrower defaults.

27 http://www.sosfaim.be/pdf/es/zoom/25_allanzas_entre_institutiones_financieras_organizaciones_campesinas.pdf

A Portfolio guarantee in Palestinian Territories (to try) to compensate the contextual risk

The challenge is the perpetuation of the existence of microfinance institutions in Palestinian Territories and in particular strengthening the security of their portfolio exposed to a specific risk as a result of the Arab-Israeli conflict.

To meet this challenge, the Company SIDI (Solidarité Internationale pour le Développement et l'Investissement, www.sidi.fr) helped to set up a "Palestine Guarantee Fund" with 300,000 Euros for a "pilot" operation. The system applied, notably by ACAD (Arab Center for Agricultural Development) and ASALA (Palestinian Businesswomen's Association) with a total portfolio of some 3 Million Euros, will be set up in the entire microfinance sector in the occupied territory. This portfolio guarantee does not cover commercial risk, but just the established and objectified effects of the occupation.

Some countries have also experimented the portfolio guarantee in hedging provided to a loan portfolio converted into securities ("securitized") to permit their sale on the capital market. More specifically, first a financial institution sells a homogeneous loan portfolio to a special purpose vehicle-company (SPV) that issues securities in the capital market. The SPV is created for the sole purpose of purchasing loan portfolios for securitization, that is to say sell them in the form of securities. The intervention consists of providing a full or partial guarantee to these securities on the market.

The distribution channel refers to the difference between direct and indirect guarantors:

- **Direct guarantors** address themselves directly to the SMME credit market. They sign a framework agreement with financial institutions by which they commit to carry a portion of the loss incurred in defaulted credits in accordance with the provisions of the contract.
- **Indirect or counter-guarantors** protect the main guarantor by participating in his losses. These are States, Regions or their public agencies or even international financial institutions²⁸. Recognizing the social value of the guarantor's activity, they form a protecting network. Many methods are possible.

The counter-guarantor can intervene by replacing the main guarantor unable to meet his obligations (double default scenario). Or he can participate on a case by case basis in each of the individual losses suffered by the main guarantor. The objective is to increase solvency by splitting up the risk and increasing the incentive for commitment.

For more information on "guarantee products" see section 3.5.5 below.

1.4 The nature of guarantee institutions

This is about ownership, legal form, permanence of activity, and the involvement of shareholders in the management of the guarantee institution²⁹.

Guarantee schemes are usually classified into two categories.

1. **Guarantee Companies** are subject to the law applicable to commercial firms. In this legal framework context, their status is the result of an agreement between shareholders that provide private and/or public equity permanently in the course of time. Shareholders participate in the functioning of the company boards and bodies in accordance with corporate law. The purpose is exclusively the provision of guarantee. **It includes:**

28 For example the European Investment Fund www.eif.org

29 Pablo Pombo, Doctorate Thesis University of Cordoba.

- Mutual Companies are joint initiatives of a number of independent businesses or their representative associations that are committed to provide a collective guarantee for loans granted to their members. The latter participate in capital formation and management of the company, often cooperative in nature. The philosophy is based on the sharing of responsibility, decision-making by peers, and full compatibility with the principles of market economy. Despite this special private character, some of them do receive public support.
- Corporate commercial companies are commercial companies or institutions governed by company law like, for example, limited liability companies, public limited companies or companies whose resources are mixed with public or financial sector predominance.
- **Programmes managed by specialized institutions:** Their execution is decentralized towards a third party organism specialized in economic promotion or support to SMMEs (public agency, development bank, public financial institution). The financial responsibility of the activity “guarantees” is detached from the equity of the institution but ultimately relies on the public budget that created the programme.
- **Programmes run in an administration of public law.** The latter manages the account and settlement in accordance with current objectives of the public authority. Though no company is created, there may be a committee in charge of decision and management.

2. **Guarantee programmes.** The guarantee is exercised within the legal or normative framework of a public or administrative institution according to a regulation governed by an administrative or political decision. Limited and temporary public resources (guarantee funds) are then devoted to a specific purpose and are generally administered like autonomous assets. Supervision is exercised according the rules of control of public accounts or under the rules that govern the institution in charge of management.

2. Quality standards for guarantee schemes

This chapter presents quality standards which have proved to be necessary in significantly reducing the risk of slippage of guarantee schemes. These standards include:

- risk partnership with the credit institution or leasing company (chapter 2.1)
- integration of guarantee schemes into the financial sector (2.2)
- a professional analysis of guarantee requests, for only viable projects (2.3)
- a rigorous risk management (2.4)
- a strict limitation of risks taken in the agricultural sector (2.5)
- suitable guarantee fees (2.6)
- establishing shareholder groups which are really interested in success (2.7)
- conservative investments, cash management (2.8)
- effective monitoring procedures, restructuring and default management (2.9)
- performance indicators: sustainability, additionality (2.10)
- subsidiary and strictly limited government support (2.11).

2.1 Risk partnership with a credit institution or leasing company

2.1.1 Avoid the exemption from responsibility of the partnering credit institution³⁰

Granting credit to a company – big, small or micro – gives rise to a “counterparty risk”, that is to say the risk that the credit becomes distressed and remains unpaid, causing a loss to the lender. Awarding a lease contract or leasing can cause losses to the financial lessor if lease fees are not paid and the leased object is sold at a loss. Leasing guarantees are not discussed here in detail, because the quality standards provided in this manual shall apply *mutatis mutandis* to them as well.

Many banks and leasing companies in developing and emerging countries, but also in industrialized countries, consider credit risk especially high for SMEs, rightly or wrongly. To overcome the resulting credit/leasing reluctance towards SMEs, several guarantee schemes have tried to promote SME credit through counterparty risk cover of 100 % by guarantee schemes.

30 The term “credit institution” is understood here as any financial institution that grants credits (especially banks, microfinance institutions)

100 % risk cover

The **CESGAR** (Confederación Española de Garantía Recíproca) network provides a 100 % counterparty risk cover leaving the banker with only the function of funding provider and interest rate risk manager. It has been transposed to Latin American countries (El Salvador, Argentina), which took over the architecture of the system.

In this scheme, the Mutual Guarantee Company covers 100 % of the defaulting entrepreneur's unpaid credit. But in return, it benefits from collateral constituted by the entrepreneur and it is also the one managing the risk, deciding the moment when the entrepreneur has lost credibility and eventual denunciation/calling in. Therefore, it is also the one that pursues the realization of collateral to its sole benefit. This approach requires a complete and developed logistics by the guarantor, who must be able to ensure alone loan monitoring, set up and the monitoring of the collateral value as well as legal proceedings against defaulting debtors.

What are the disadvantages of a 100 % coverage of losses by guarantee schemes?

- First, guarantee schemes – and in particular guarantee companies – have skills in risk assessment, but they often have a specific view, different from that of the banker. They focus mostly on the qualitative aspects of loan applications, like the applicant's training and motivations, and the compatibility of applications with local economic elements (customers, competition, price, technology). The credit institution, for its part, applies conventional methods of analysis of credit documents based more on financial aspects: profitability, indebtedness, and need in working capital ... These methods applied jointly provide an added value while strengthening the activity of credit institutions, or else high defaults are looming. If credit risk were to be withdrawn from the lender owing to an external guarantor covering 100 % of losses, the dual approach wouldn't make sense any longer and something "virtuous" in the process would be lost.
- Moreover, in case of full guarantee, the supervisory authority could find that the guarantor actually acts as a bank and is susceptible to create a systemic risk, forcing it to more rigorous prudential rules. The social goal of the instrument would vanish.

- Finally, if the loan happened to be unpaid, a lending institution that would not bear any own risk would not have any incentive to try to rescue the client or to initiate appropriate legal action in due course.

100 % risk taking by guarantee schemes should therefore be an exception, applied in very special³¹ cases. In Japan, in 2007, the "system of sharing responsibilities with financial institutions" was introduced; the mechanism in which Credit Guarantee Corporations had, as a rule, assumed 100 % of the credit risk was turned into a system in which financial institutions were required to assume 20 % of the risk.

However, even if the guarantee scheme's share of the risk is less than 100 %, the credit institution can nevertheless remain without actual risk if it has a priority right on the recovery of collateral in case of a default. Thus, let us suppose that the contractual rate of guarantee is 65 % of outstanding capital and interests due, and that the probable product of the liquidation of collateral (for example, sales of pledges) reaches 40 % of loans outstanding in default. If the credit institution has a priority right to the proceeds of the recovery of collateral, it will be compensated at 100 % of the credit amount outstanding.

31 Gray et al. (OIT, 2000) mentions the case of mutual guarantee funds which have a very peculiar shareholding that, in addition to assuming the tasks and responsibilities of the lending institution, would allow them to successfully grant guarantees covering 100 percent of the risk

There are ways of avoiding exempting responsibility of the credit institution and ensuring good partnership among the parties:

- The guarantee is partial (for example, 70 % of the total loan + interests due) and covers only the net loss of the credit institution, after recovery of all the other collateral (compensation guarantee). Recoveries are shared *pari passu* between both parties.
- In cases where the credit institution has privileged or exclusive recourse to collateral (see for example the model “joint and several with the banker” below) the rate of cover of the credit amount should be as limited as possible, such that the credit institution cannot be assured in advance of not suffering any loss in case of default. The precise percentage of credit cover should be determined according to the local situation, especially the recovery value of collaterals. Clearly, the character of “incentive” of the guarantee would be weakened.

2.1.2 Principal models of credit institution compensation

According to choice, the main compensation patterns by the guarantee scheme used in practice vary:

- The preferred paying off model of the credit institution is sometimes called “**joint and several with the banker**”. In this model, the guarantor indemnifies a previously agreed percentage of the outstanding credit balance at the time the loan is declared to be in default. Upon indemnification, the lender can take legal action against the ultimate debtor on the basis of the collaterals he put together for his own benefit. In this case only the lender benefits from the realization of the borrower’s collateral.
- otherwise, the guarantor can intervene by applying the percentage stipulated in the contract on the amount of the final loss, after loan termination by the lender and the realization of collateral granted by the borrower. This system is called “**loss sharing**” Recoveries benefit to both parties, in proportion to their respective intervention rates. They therefore act as partners.

A comparison of the systems

Let us compare the two systems for an investment loan (purchase of machine) of 100 which is covered by a deposit of bond securities of 20, the lien on the machine and a 70 % guarantee of a guarantee company. This loan is in default to a debit balance of 84 (outstanding principal 75 + unpaid interest 9).

The legal action against the debtor will allow recovering 20 out of the bond securities; the machine is out of use... The final loss balance is $84 - 20 = 64$.

“loss sharing”

The guarantor loses: $64 \times 70 \% = 44.80$
 The lender loses: $64 - 44.80 = 19.20$.

“joint and several guarantee”

The guarantor loses: $84 \times 70 \% = 58.80$
 The lender loses: $84 - 20 - 58.80 = 5.20$.

What are the consequences of the application of one or the other principle?

- In the “joint and several” model, the lender is tempted to make up the collateral only for the part that corresponds to his “dry” risk. The partnership between the guarantor and the lender is exposed to perverse practices because the guarantor runs the risk of being the only risk bearer.
- If the guarantor is the only party exposed, he will also try to be covered by some kind of collaterals on the debtor, undoubtedly of lower quality than those applied by the lender. But a double pressure will then be exerted on the borrower to give collateral, which is contrary to the spirit of facilitating access to credit.
- Still in the “joint and several”, each party will try separately to form their own opinion on the likelihood of loss and recovery. Guarantor and lender are each seeking their own truth on the outstanding at stake. On the other hand, in a “loss sharing” guarantee, the two parties know that they will jointly be liable for the loss and joint recovery beneficiaries. They will cooperate better in decision-making.
- Finally, contrary to all appearances, the “loss sharing” mechanism does not require the lender to wait until the end of the procedure to receive payment from the guarantor. He can receive a provisional amount at the moment of default, then a payment adjustment on determining the ultimate loss.

The philosophy of the mechanism and the handling of diverse coefficients define ex ante risk sharing according to diverse methods:

1. **Loan items included in the protection:** is the protection on the outstanding principal of the loan or on the principal plus unpaid interests or even on principal, interests plus fees incremented by the banker? These formula have their advantages and disadvantages:

- if the guarantor refuses to cover interests due, the banker may be tempted to terminate/call in the loan more rapidly, once a delay in interest occurs.
- if the guarantor participates in the costs of prosecuting the denounced debtor, the lender may be tempted to take more intensive recovery actions.

2. Is the percentage of credit covered 50 %; 70 % or 80 %?

- Lower percentages of cover are possible, as long as the guarantee has a stimulating effect on the loan grant. Negotiated rates of between 38 % and 45 % are noted in certain systems. According to a recent World Bank study³², benchmark cover rates are generally above 50 %.
- Cover can be modulated according to products: for example a policy to encourage start-up companies can lead to raising the protection rate in comparison with an enterprise having existed for several years. Cf. section 3.4.1 below.

3. The duration of protection. In principle, loan is covered up to its final due date but there can be limitations

- An absolute statutory limit: 5 years, for example.
- A second conventional limit: when the parties decide to stop the guarantee earlier than the maturity of the loan. The total guarantee fee amount is then reduced but the guarantor sees himself committed to cover the first years of the loan which are often the most risky.

4. **Guaranties matched with a stop-loss:** the guarantor covers, but up to a ceiling in absolute value defined by the contract for the total amount of losses.

32 World Bank (2010), Table 5, p. 14

5. Finally, risk sharing may provide for the subrogation of the guarantor to the rights of the lender³³. The guarantor would thereby legally take the place of the lender,

after having compensated the latter. The guarantee scheme would become entitled to the outstanding claim.

Products with varying criteria

The Jordan Loan Guarantee Corporation has existed since 1994 as a public limited company with a registered capital of about 7 million euros. It distributes various guarantee products each with its own characteristics:

- Investment guarantees have a rate of cover ranging from 50 % (credits exceeding 40,000 Euros) to 75 % (the smallest). The duration is 5 years with one year's grace period. The charge is 1.5 %.
- Guarantees for industrial modernization can reach up to 400,000 Euros for 8 years with three year's grace period
- Land acquisition guarantees are lower in amount (30,000 Euros with a personal investment of 50 % by the buyer. But the duration can be 10 years with three month's grace period.
- Export risks are protected up to 85 % of the loss resulting from political or commercial events. The guarantee fee is fixed on case by case basis.

We thus see that risk sharing parameters are modulated according to diverse internal policies.

A risk partnership between lender and guarantor also requires the following precautions:

1. Except in the case of portfolio guarantee³⁴, it is advisable to specify the credit bearing the guarantee and to verify that the guarantee is not on a loan that has already been granted by the lender. Failing which, the credit institution could extend new loans which are substituted for older loans in distress and then free itself from risk at the expense of the guarantor.
2. For loans repayable in installments, such as term loans for investments, the guarantee must be reduced to the amount actually due on each settlement date of the programme. For loans without fixed term, the guarantee must be limited in time, but may be renewed.
3. Unless in case of exceptions, avoid providing guarantees in advance for loans that replace guaranteed loans that have come to maturity: if a new operation opens with a new goal, a new decision must be taken. Otherwise there is a risk that non-performing loans are simply rolled over, with a new guarantee cover.
4. Do not provide guarantees for loans to businesses that are already in difficulty. **Guarantees can compensate for deficiencies in collateral, but not for deficiencies in commercial viability/ profitability³⁵** (cf.2.3 below).
5. It is imperative that the **default event, triggering an obligation to pay compensation** on the part of the guarantee scheme **be clearly defined in advance**. Inaccuracies in the definition of criteria and indicators of the realization of the guarantee are factors of loss of confidence of the lending institutions in the guarantee system.

33 Subrogation is the assumption of the rights of the lender by the guarantor, giving him the right to pursue an recourse on the basis of assigned rights

34 Portfolio guarantee authorizes a credit institution to enter, without prior approval of the guarantee mechanism, all credits that meet certain criteria, cf. section 2.2.2 infra

35 Linda Deelen & Klaas Molenaar (2004), "guarantees cannot possibly turn a bad investment into a viable one", p. 7

6. In the case of a fairly high rate of guarantee, for example 80 %, the guarantee scheme must, even in “loss sharing”, **take precautions to prevent the lending institution from dodging to bear an actual risk**. Thus, the lending institution may try to reduce its residual risk of loss through very high interest margins. The guarantor must therefore, in cases of high coverage, check that the credit institution’s margins remain normal, especially as the risk of the latter is lessened by external cover.

It is advisable to take account of these precautions as much as possible in the guarantee agreement signed between the lender and the guarantor (see also sections 3.5.4 and 3.5.5 below)

Some guarantee systems may grant a guarantee to the beneficiary/loan applicant (entrepreneur, microfinance institution) instead of (or before) entering into a contract with a credit institution. The beneficiary/borrower will then be able to present the guarantee to the lending institution as surety. A precaution however: in the case of the issuance of a surety instrument by the guarantor without prior contract with the lending institution, it is advisable to specify clearly the conditions under which the guarantee is legally valid.

So, there are two channels to put the entrepreneur in touch with the guarantor:

- through the channel of the lender, consulted in the first place and who takes a decision subject to the guarantor’s consent before any formal agreement made with the applicant,
- directly with the applicant, the lender being visited after the guarantor’s decision and taking a decision on the basis of a partial guarantee already acquired and an application file already established.

2.2 Integration of guarantee schemes into the financial sector

There is a clear similarity of risks in the provision of a guarantee or credit. In both cases, there is the risk of default, therefore of loss. The technical term is “counterparty risk”. For professionals, the guarantee instrument is a special case of “credits (or commitments) by signature”, like documentary credits and stand-by credits.

Commitments by signature

Signed commitments or financial guarantees (credit by way of guarantees) differ from other forms of credit because they do not involve any immediate availability of funds, but only a possible outlay of funds later. In the case of guarantees, guarantors pay money to credit institutions in cases of credit default losses (loans on default) well defined by contracts.

S

As the granting of credits requires a professional analysis, the same is the case with credit guarantees (see section 2.3 below). Too often guarantee funds have been created outside the financial sector, without professional staff. It is preferable to create such funds as financial institutions

(for more details see Chapter 3.2) or integrated into a professional financial institution (cf. section 2.7.3 below). Some consequences are described in what follows and in chapters 2.3 – 2.9 below.

2.2.1 Prudential regulation

Guarantee companies claim a place on the arena of specialized financial institutions. Their positioning in

the financial sector is reflected in some countries by the alignment of their prudential regulation with that of banks.

Prudential regulation

In almost all countries, banks are subject to a regulation called “prudential”. This regulation aims to protect savers who entrust their assets to a financial institution, as well as the protection of other market institutions with which the institution makes reciprocal operations of purchase and sale of money.

Decreed by Government/the Central Bank, prudential regulation thus aims at ensuring security and stability, among others, by minimal norms of equity and liquidity. These standards are called “**prudential rules**”.

These standards are expressed as principles and “ratios” to be observed by credit institutions. One of the most important ratios (RAR standing for Risk Asset Ratio) prescribes a backing of the volume of counterparty risks (credits granted, commitments accepted, ...) through a minimum equity of x % of their value. For example, if this percentage is 8 %, a volume of 100 million Turkish Lira credits granted requires at least 8 million TL of equity.

Two consequences can be highlighted:

- On the one hand, the expansion of total counterparty risk is strictly limited by such a ratio. For example, a credit institution has 200 million equity. On that basis, with an 8 % equity backing rate, it can grant maximum credits of 2.5 billion (200 x 100 / 8). If it wants to extend more credits, it must first mobilize additional equity.
- On the other hand, the equity backing needed in each loan extension raises the cost because, among the bank’s financial resources, equity is normally the most expensive for the simple reason that shareholders expect dividends that are higher than interest rates.

The “**Basel II**” and “**Basel III**” agreements concluded in 2004 and 2011 between Central Banks ³⁶ a, it was agreed to modulate equity requirements according to the level of risk which depends on the type of debtors and the type of collaterals offered by debtors (e.g. lending on the basis of mortgage is less risky than lending without surety). Guarantees by third parties have been recognized to reduce prudential equity requirements for credits under certain conditions :

- The guarantee must be binding on all parties and legally enforceable in all relevant jurisdictions (see Basel II 2006, paras 118, 140)
- “The bank must have the right to receive any [compensation] payment from the guarantor without first having to take legal actions in order to pursue the counterparty for payment” (Basel II 2006, para 190 a)
- Guarantees must be “direct, explicit, irrevocable and unconditional” (Basel II 2006, para 140)
- The duration of the guarantee must in principle correspond to the duration of the loan (Basel II 2006, para 182).

The final consequence of the guarantee is a reduction of the requirement of prudential equity of the partner-credit institution.

When the credit institution benefits from this effect, the guarantee company adds a second role to the original one of being “an external loan risk provision fund”: it becomes a tool of economising credit institutions’ equity

Following the example of prudential rules for banks, prudential rules can also be enacted for financial institutions subject to a systemic risk, microfinance institutions, and guarantee companies.

36 Basel Committee on Banking Supervision, International Convergence ... (2006). N.B. : Basel III (2011) replaces only parts of Basel II (2006), not the whole Basel II document. The quotes above from Basel II (2006) are still valid

The integration of guarantee schemes into the financial system by prudential regulation can equally be done through a specific legislation, adopted by a certain number of countries (cf. also section 3.1.4).

Such legislation typically describes:

- the conditions for the admission of a company into the network of “guarantee companies” and the protection of the name
- the professional qualifications required of the direction and administration organs’ members
- economic conditions of operations (solvency, liquidity, and loan loss provisioning ...)
- monitoring and control mechanisms as well as sanctions.

Similar to banking regulation *sensu stricto*, these requirements aim, through prudential control, to see to the “survivability” of guarantee companies by strict compliance with general conditions. They provide a pillar to the confidence between partners and prevent a systemic risk caused by the failure of guarantors.

The manifestly financial nature of guarantee companies is expressed furthermore through their internal organization as well as through their tools used (policies and techniques for decision making and risk monitoring, internal control, and external audit ...).

Finally, their synthetic accounting records – balance sheets and income statements – are often read like bank reports from the point of view of the information produced and certified by an external auditor.

2.2.2 Specific financial statements

The supervisory authorities, being very vigilant vis-à-vis the financial sector, normally prescribe specific rules for keeping the accounts of these institutions. Besides, in most countries they require periodic statements to be approved by external audit firms, and centralize them in databases. It is the same with guarantee companies.

Accounting standards are meant to standardize methods and make business operations and their financial statements transparent vis-à-vis third parties. The most important instruments are the balance sheet (including off-balance sheet records) and the income statement.

The balance sheet gives a picture of the business assets from two points of view:

- First, the uses of funds listed according to a specific structure in the “assets”.
- Then, the financing structure of the total of these assets is presented on the “liability” side (debts and equity, but also “provisions”, see Box 2.4.1).

Assets of guarantee companies include cash and other liquid assets, receivables (for example, receivables from the credit institution borrowers received on the basis of subrogation³⁷, after compensation of the lender by the guarantor), financial investments and fixed assets. Financial investments form the bulk of the assets.

37 legal substitution of a creditor by another. For example, after compensation of a credit establishment by a guarantee mechanism, the latter then becomes owner of the outstanding claim

Liabilities in the balance show the financing of the assets, namely

- equity (capital, reserves, retained earnings) and quasi equity (grants and subsidies with a permanent character)
- debt (including those to credit institutions as a result of triggering of guarantees).

Moreover, there are provisions for risk (= probable³⁸ debt to banks, resulting from non-performing loans³⁹) and general provision allowances that are not ascribed to a particular risk and which are assimilated to Internal Security Funds of credit institutions and thus to Tier 2 equity⁴⁰.

A guarantee company's balance sheet could have the following simple structure:

Assets		Liabilities	
Cash and bank accounts	... Mio	Short term debt, including outstanding claims by lenders	... Mio
Receivables	... Mio	Provisions <ul style="list-style-type: none"> ● general ● specific for probable losses on non-performing loans 	... Mio
Financial investments	... Mio	Equity	... Mio
Tangible and fixed assets	... Mio	Retained earnings (+), losses (-)	... Mio

Guarantees provided do not feature on the balance sheet in traditional accounting. They represent future potential risks. However, in traditional accounting they are not considered as debts so long as they are not called or “mobilized” by the credit institutions. They are commitments that appear **“off balance sheet”**.

In contrast, International Accounting Standard (IAS) 39, published in 2005 by the International Accounting Standards Board (IASB), requires the guarantee issuer to present “financial guarantee contracts” by their “fair value”. The professional literature⁴¹ considers possible a gross or

a net accounting. In gross accounting of financial guarantees, the present value of guarantee premiums to be received is entered on the assets side of the balance sheet and the “guarantee liability” on the liability side. The net method permits – like traditional accounting – net values of zero, if performance and consideration can be considered equivalent and “unless there is evidence to the contrary” (IAS 39 Appendix A, AG 4, (a)^{42,43}. – After the fair value treatment of lending instruments including guarantees was met with criticism⁴⁴, IASB decided on IFRS 9 which is in preparation to replace IAS 39⁴⁵.

38 see Box in section 2.4.1

39 to be specified later

40 Basel III permits this up to a maximum of 1.25 percentage points of credit risk-weighted risk assets

41 for example Kuhn & Scharpf (2006) paras. 1323, 1324

42 IFRS 2011, IAS 39

43 cf. Kuhn & Scharpf (2006), paras 47, 1322, 1323

44 see for example Basel Committee on Banking Supervision (2009), p. 1

45 for further information see, for example, KPMG (2010) and Ernst & Young (2012)

In practice, the accounting treatment of guarantees extended is not uniform. In the West African Economic and Monetary Union (UMEOA) zone, for example, guarantees extended are entered in chapter 9 of the Accounting Standards but not in the balance sheet (however “off balance sheet”).

Guarantees that are likely to be called/mobilized because the guaranteed loan has become distressed, must be entered under “provisions” both along traditional and IAS⁴⁶ lines.

The Income statement of a typical guarantee company includes the “expenses” and “income”:

Expenses		Income	
Gross wages	... Mio	Financial income	... Mio
Operating costs			
Depreciation on tangible assets	... Mio	Guarantee and administrative fees received	... Mio
Allocations to provisions	... Mio	Miscellaneous income	... Mio
“Compensation payments, unless covered by Provisions			
Profit (+)	... Mio	Recoveries on guaranteed credit losses	... Mio
Losses (-)			

Income of guarantee companies are of four kinds:

- operating income made up of guarantee fees received for the part assigned to the financial year⁴⁷ and possible commissions received for application file review or monitoring of the guarantee
- financial income generated by interests and commissions on financial investments
- miscellaneous income among which subsidies received
- revenues associated with recoveries on credit default losses received after indemnification of the lender

Expenses (in the accounting sense) of guarantee companies/funds are of threefold:

- operating expenses: salaries, rents, marketing, and others corresponding to the functioning of the institution
- depreciation of tangible assets
- costs inherent in the business of guarantor which are provisions and losses (see chapter 2.4.1), as well as compensation payments to credit institutions unless covered by provisions.

46 IAS 39.47 (c)

47 It may happen that the guarantee fee is received at the time of extension for the whole duration of the guarantee. In this case, the amount should be broken down between the part allocated to the year due and the part relative to the subsequent years (to be entered as a provision)

In accounting terms, provisions are established by debiting the income statement and credit entries to a provisions account which appears in the balance sheet. If a compensation payment to a credit institution occurs, the balance sheet provisions account is debited and the bank account is credited. If a doubtful and provisioned account becomes sound and standard once more, the balance sheet provisions account is debited to an income statement “provision reversal” account.

The external analyst wishing to discern losses on guarantees will generally look at the change in the balance sheet account “individualized provision for risks”.

2.3 Provision of guarantees to viable projects following a professional analysis

In practice, retail guarantee schemes conduct themselves analyses of loan documents, alongside the credit institution. This is not necessarily a useless duplication because guarantee companies’ added value depends on proximity to the customers and through “the presence of entrepreneurs’ representatives in the commitment committees [of guarantee schemes], giving them a vision that is different from that of the banker”⁴⁸. Researchers Francesco Columba et al. go even further by affirming that “our findings are consistent with the view that MGIs are better than banks at screening and monitoring opaque borrowers”⁴⁹ (MGI = Mutual Guarantee Institution).

When there is a case by case double screening by the guarantor and lender, it is proper that the perspectives of the two analysts differ. The banker will normally consider the usual standard data for financial analysis and forecasts of business plans. The guarantor will give more weight to the qualitative elements of the loan documents: the applicant’s training and motivation, compatibility of the loan documents with elements of the local economy (customers, competition, price, and technology). He provides an answer that takes greater account of the immaterial or intangible aspects of the dossier. Through this difference of approaches, the complementarity of analysis will not be an additional filter leading to refusal but an additional aspiration to the granting of credit. The additional analysis by the guarantor can also decrease bankers’ fears of hidden high risks in proposed loans, a fear which is greater when loan applicants offer only low collateral.

In other cases, the guarantee scheme itself does not carry out the analysis of individual credit/guarantee documents at the time the loan is granted. An important example is that of **portfolio guarantees**. “Portfolio” guarantee is used for the automatic cover of a preset volume of loans made by a lender. However, the guarantor retains control by requiring that this pool of transactions meets criteria laid down by him: the percentage of maximum cover, the size of the guarantee, the purpose of the loan as the case may be, borrower’s minimum financial structure, diversification of the portfolio according to branches and minimum standards of analysis⁵⁰ ensuring the ex ante viability of projects funded...

Here, for example, is the case of a portfolio guarantee scheme in Palestine, with features that reflect the very difficult situation faced by small entrepreneurs in the country:

48 André Douette (2003), p. 48

49 Bank for International Settlements (2009), p. iii

50 See for example: Suhlrie (2006), page 717

Stage	Description
1	Application for loan: customers to the MFI (ACAD or ASALA)
2	MFI's decision: approval of the loan by the Credit Committee (weekly)
3	Notification: The MFI presents the portfolio to be covered to the guarantor
4	Reception at the guarantor's: The list is signed to acknowledge receipt, in duplicate, one for the MFI). It restates the elements: No. of the loan, name, location, type of project, approved amount, duration, legal form, security interest, date of application, approval date by the MFI and comments.
5	Loan grant: The MFI grants and disburses the credit
6	Notification of delays: in case of late payment, the MFI sets up its usual recovery policies. The MFI can call the guarantee by proving that the forced reimbursement process has been launched on the security interests (for example, the letter of exchange has been sent to a lawyer with the collateral and credit agreement. Earlier, the MFI visited the borrower twice and the bank has certified the default).
7	<p>Special circumstances relating to the eligibility of the cancellation of the loan:</p> <p>The expected decline in purchasing power created by the imposition, by Israël , of income taxes or financial boycott of Palestine,</p> <ul style="list-style-type: none"> ■ Export restrictions (despite an agreement signed with Israël or with international customers), ■ Objective evidence that the project initiated by the entrepreneur has been destroyed, ■ Entrepreneur imprisoned for political reasons for more than two months. Murder of the entrepreneur or a member of his family for political reasons, ■ Curfew of long duration (arising after the grant of the loan) or isolation of the region with obvious economic consequences: stoppage of the production process or production cannot be sold as a result of the closure of markets (specially for agricultural products), ■ Confiscation of land harbouring the project.
8	<p>Call of guarantee:</p> <ol style="list-style-type: none"> 1. Every 3 months, the MFI sends the detailed list of customers and the outstanding balance with the overall amount to be paid. The guarantee company has one month to review the list and can, during this period, investigate the good faith of the information from the list. 2. After a month, the MFI is authorized to ask for the amount from the Credit Guarantee Secretariat, with a copy to the guarantee company. 3. The guarantor has one week to put forward his approval, refusal or the discrepancies. 4. The approved amount is paid immediately. 5. The amount over which there is disagreement is put to discussion between the MFI, the guarantor and the Credit Guarantee Secretariat. In case of new disagreement, the secretariat has the final decision.

In any case, it will be necessary to make a professional analysis of the likely potential loss (the elements called PD (probability of default), LGD (loss given default), EL (expected loss) in the Basel Accords). **The principle is that**

guarantees should be granted only for projects that will most likely⁵¹ be viable. Guarantees can compensate a lack of collateral, but not a lack of viability/commercial profitability.

51 not only in favourable conditions

There are very sophisticated examples, like FINNVERA in Finland, for which more than 100 business analysts make ratings and estimations of default probabilities in each case. Although such sophistication exceeds the resources of most guarantee schemes, one should equally be wary of overly simplistic methods. Neither is it advisable for

guarantors to adopt too advanced rating methods⁵². It is sensible to formalize the decision criteria, to use them systematically, and to verify, in case of default, what did not work. In this way, we enter into a learning process which over time permits the progressive adoption of a “scoring”⁵³ methodology.

Cyclical sensitivity of guarantee companies

In principle, guarantee schemes are less sensitive than banks to illusions caused by the artificial inflation of collateral values in times of economic overheating or speculative bubbles.

The period preceding the peak favours excessive credit granting (see the 1997/98 Asian financial crisis or the 2007/8 financial crisis in the United States). The period following the shock is often marked by a credit crunch and by lower recovery flows on defaulted commitments.

In Europe, after the 2001 and 2007 crises, it could be observed that each national guarantee scheme was able to register improvement in its outstanding amount, while the venture capital industry was collapsing at the same time.

However, guarantee schemes will equally be wary of excessive optimism nurtured by an overheating of the economy. During a seminar of the European Mutual Guarantee Association in 2006 on prevention and resolution of failures in guarantee companies, a British study was mentioned which observed that larger guarantees granted during boom situations were the ones that generated the highest loss rates.

In addition to qualitative analysis, guarantee schemes also check the borrower’s contractual commitments.

Examples of such contractual commitments (covenants) are :

- compliance with some ratios, like maximum rate of indebtedness, working capital
- prohibiting the borrower from focusing on his private withdrawals at the detriment of the profitability of the company, before paying interests and repaying secured credit
- prior paying in of borrower’s own means/equity before the guaranteed credit funds the planned operation
- (sometimes) submitting investment projects above a certain size for the approval of the credit institution and/or guarantee scheme.

52 Rating is a sophisticated technique which helps to evaluate a priori values as % of loss parameters (P.D, the default probability and L.G.D., loss given default) at the time of the application and, besides, to update these values at least once a year. The method used to arrive at these assessments is not prescribed. If it is left to the lender’s discretion, it is on the other hand the subject of control by the banking supervisor, who evaluates its accuracy as a forecasting tool. The value of PD and LGD enables financial institutions that practice the so-called “ advanced approach ” to allocate each item in the credit pool of a specific portfolio, which requires a certain volume of equity capital.

53 Scoring allows the financial analyst to systematically and statistically rank customers by financial risks. It consists of defining decision criteria –be they numerical values or qualitative features- in a limitative manner, of predicting possible responses and of giving to each one a certain number of points. At the end of the template questionnaire, the application receives x points. According to the cut-off line, the application is accepted or rejected. A lot of scorings provide that beyond mechanical application, human intervention remains possible to “correct” the system.

Finally, a mistake to be banned absolutely is “influence peddling”: the guarantee scheme organization must be rid of any external intervention aimed at promoting any

protected case. It is enough to have just one case for a second one to occur ...

A system open to influence

When opening to the market economy, a European country decided to create a public guarantee fund for loans to SMME. Unfortunately, this scheme had not been made impervious to external influences favouring particular requests regardless of the intrinsic value of the projects.

The penalty was twofold.

In the immediate, the system had to be stopped.

Later, at the time a more robust scheme was inaugurated, banks had lost confidence and the fresh start was very laborious.

It may be appropriate to distinguish the Commitments’ Committee from statutory bodies such as the Board of Directors. The latter does its statutory work but does not intervene in guarantee decisions where there are independent experts and representatives of the business circle deciding by majority or better on consensus.

The requirement to limit guarantees to ex ante viable projects holds particularly in cases where the State

renders support (for example by counter guarantees, cf. chapter 2.11 below) or grants guarantees itself. Above all, public guarantee programmes must provide professional procedures for analyzing credits to be granted, limiting public intervention to projects proving commercial viability. For example, when the Federal German Government intends to offer a guarantee, it needs a favourable opinion based on risk analysis carried out by an external audit firm.



2.4 A rigorous risk management

What risks are to be reckoned with in the practice of guarantee schemes? The overview that follows has been partly inspired by “Risk Management Framework for Microfinance Institutions” published by the German Technical Cooperation Society (GTZ, now GIZ)⁵⁴ while focusing on the special risks of guarantee schemes, and notably guarantee companies⁵⁵. In the practice of guarantee schemes it is important to take into account all risks that can threaten their survival and develop strategies to control them.

Notably, the following risks are relevant:

1. **counterparty risk** due to the possibility of default of guaranteed individual loans;
2. **portfolio risk** jeopardizing a guarantee scheme as a result of a “portfolio” of guarantees not – or not enough – diversified ;
3. **liquidity risk**, meaning that unexpected calls by credit institutions for payment of guarantees may exceed the liquid means of a guarantee scheme;
4. **market risk**, referring to the value of financial investments;
5. **operational risk**, in connection with computer technology, fraud, corruption and other offences;
6. **risks linked to strategy errors.**

The challenge of guarantee schemes in the form of companies or guarantee funds is to control all these risks. Public and parastatal guarantee programmes will control especially risks Nos. 1, 5, and 6; however, the management of Government and parastatal guarantee programmes shows peculiarities that will be addressed in chapter 2.11.

Risk management of guarantee companies and private guarantee funds will be focussed on in the following.

Risk control, studied in the sections that follow, requires above all:

- evaluation of counterparty risk (= default risk) before granting guarantees and sharing this risk with the credit institution (see chapters 2.1 and 2.3)
- accounting precautions (“loan loss provisioning”), addressed in section 2.4.1
- sufficient equity, section 2.4.2
- limiting the maximum volume of guarantees to be granted (2.4.3)
- counterparty (credit) risk diversification (2.4.4)
- limiting the number of “big debtors” (2.4.5)
- good cash/liquidity management (2.4.6)
- “operational risk” control, including safeguards against corruption (2.4.7)
- a total risk control system, as a management task (2.4.8).

A separate chapter will treat agricultural credit guarantees, which requires a specific approach (see 2.5).

54 MicroFinance Network & Shorebank Advisory Services (2000)

55 only a few essential aspects can be addressed here; for a more detailed presentation see, for example, Calvet (2002)

Risk control – the case of ASKINDO in Indonesia

In Indonesia, ASKINDO Guarantee Company was founded in 1971 because banks were obliged to ensure their entire SMME loan portfolio with an external guarantor.

Various weaknesses observed in the mechanism subsequently led to a series of improvements designed to better manage and hedge the risk:

- compulsory insurance was lifted and Askindo had the right to choose banks with experience and reputation in the market segment,
- the diversification of benefitting economic sectors was maintained but “red” sectors were communicated,
- geographical diversification of interventions was maintained, but unsecure regions were excluded
- a 50 % credit cover product sharing risk with the lender was created,
- the number of credit with 100 % cover was drastically limited,
- a delegation of decision for reduced amounts of loans was decided while applications of greater magnitude were reviewed by the guarantor before decision,
- the fee rate was based on risk and the lender’s historic performance
- cooperation with international agencies organized risk sharing for specific portfolios (microfinance and fisheries)

2.4.1. Precautions in terms of provisions for credit risks

Rationale

Let us consider the following case: In 2008, a guarantee company guaranteed a five year loan repayable periodically. The company benefitting from the guaranteed loan incurred losses in 2009 and 2010 and paid off in an irregular manner. At the end of 2010, the credit institution notifies the guarantee company that the loan is considered “distressed”, but does not yet call for compensation.

Obviously, there is in this case a considerable likelihood that the guarantee be called one day, requiring payment of compensation from the guarantor to the credit institution. Would it be rational to recognize an accounting loss only at the time of the indemnification of the lender, for example in 2012 ?

The consequence of such deferred accounting would be that equity had not been adjusted to a most likely reduction while continuing to be the cushion for the issuance of new commitments! In the meantime, financial statements would disclose a false view on the company’s solvency. Good management rules require to reduce the equity with the early emergence of the risk by recording adequate loan loss provisions.

Loan loss provisions of sufficient magnitude are to reflect real and latent risks⁵⁶

The basis of an effective method is to establish a regular exchange of information with partnering lenders in order

to know as soon as possible the risks caused by possible delayed payments or through early and credible information on a deteriorated economic situation of the borrower.

56 “More important than the equity base is appropriate loan loss provisions ... If loan loss provisions are accurate and suf

In countries that do not require general loan loss provision at the level of historic probabilities of losses, such a general loan loss provision should nonetheless be entered in the books (if allowed by law or regulation) on the basis of an empirical method.

Loan loss provisioning for credit risk therefore covers two meanings:

- a **general sense** because it is easily understood that every guarantee commitment can become doubtful. A general or lump loan loss provisioning on portfolio is indicated. This is a general non-individualized loan loss provision that normally follows the evolution of the probability of the historic loss of the institution. It takes into account the existence of individual loan loss provisions.
- when an **individual risk** deteriorates, accounts show delays in payment. It is therefore important to isolate the debtor in a specific section of the off-balance sheet accounts (for example “suspense account”⁵⁷) and envisage a case by case cover.

National regulations in many countries prescribe the constitutive elements of allocations to individual loan loss provisions of financial institutions; for example, a loan loss provision has to be entered at x % in case of an unpaid loan after 90 days. At least, general accounting rules/standards are applicable, typically the rule that an individual loan loss provision is to be established if a loss has at least 51 % probability (“more likely than not”⁵⁸).

In the case of general provisions, national standards are – in most cases – less restrictive. This manual calls for the observation of Principle n° 5 of the document “Sound credit risk assessment and valuation for loans” of the Basel Banking Supervision Committee⁵⁹ which requires that the total amount of individual and general loan loss provisions of a financial institution should be sufficient to absorb estimated credit losses.

The level of individual provisioning depends on the vulnerability of each borrower. It goes from 20 to 100 %. Dialogue with the banker (mainly) or visit to the entrepreneur (subsidiarily) provides information on the way to proceed. The following table provides a pure example of “standard application” of monitoring both the accounts and the economic situation of the business.

The rate of loan loss provision is calculated on actual exposure to risk: [debit balance x the %age of guarantee taking into account probable recoveries estimated at a conservative value].

57 As reminder, guarantees given are recorded in off-balance sheet accounts (cf terminology in Annex III)

58 cf. IAS (International Accounting Standard) 37, www.iasplus.com/standard/ias37.htmrg

59 <http://www.bis.org/publ/bcbs126.pdf>: “A bank’s aggregate amount of individual and collectively assessed loan loss provisions should be adequate to absorb estimated credit losses in the loan portfolio.”

The second precaution to be taken in management is to ensure that the amounts likely to be paid by the

guarantor are available and liquid (see section 2.7 below).

Number of days of late payment	< 31 days	31 – 60	61 – 90	91 < 180	> 180 days
Good financial standing of the company	Standard	Supervision	Substandard	Doubtful	Distress
Loan loss provision:	1 %	3 %	20 %	50 %	75 à 100 %
The financial situation deteriorates	Supervision	Substandard	Doubtful	Distress	Distress
Loan loss provision:	3 %	20 %	50 %	75 à 100 %	75 à 100 %
Unstable situation with doubts on profitability, solvency	Substandard	Doubtful	Distress	Distress	Distress
Loan loss provision:	20 %	50 %	75 à 100 %	75 à 100 %	75 à 100 %
Situation deteriorates, probable non payment	Doubtful	Distress	Distress	Distress	Distress
Loan loss provision:	50 %	75 à 100 %	75 à 100 %	75 à 100 %	75 à 100 %
Irrecoverable, bankruptcy, under legal protection	Distress	Distress	Distress	Distress	Distress
Loan loss provision:	75 à 100 %	75 à 100 %	75 à 100 %	75 à 100 %	75 à 100 %

2.4.2 Sufficient equity capital

Why is equity capital important for guarantee companies and funds?

Only equity capital can compensate negative performance caused by losses and prevent insolvency. Insolvency means that the sum of assets does not cover the sum of debts (negative equity). Equity capital is therefore an important “safety cushion”. Once a company has insufficient equity capital, it risks to be unable, at one time or another, to pay all its debts. In many countries, an excess of liabilities over assets triggers a state of insolvency that can give rise to the obligation to “file for bankruptcy” and submission to a receiver (that will strive to minimize damage to creditors).

- Furthermore, the financial environment encourages establishing the credibility of the institution vis-à-vis its lenders. That is why it is necessary to permanently provide sufficient equity capital to conduct existing and future activities in full confidence.
- Finally, when equity is invested in financial investments, it generates revenue that contributes to cover general expenses.

Prudential regulation in many countries, already mentioned in the box in section 2.2.1 above, prescribes ratios between equity and risks incurred, in the case of guarantee companies: commitments taken⁶⁰. A ratio often used is the one prescribed in Basel agreements (formerly called Risk Asset Ratio), namely 8 %.

60 except for guarantees that are covered by counter-guarantees

Abstracting from the weighting of risk incurred prescribed by Basel II and III (and increasingly practiced by supervisors), the 8 % ratio means that a volume of guarantees of 100 million would require 8 million equity capital. But, can managers of guarantee companies be satisfied with complying with the prudential ratios applicable to banks to determine their safety net? Most of the time, practitioners' answer to this question is, no. The main reason is that prudential standards are considered minimum standards that are not necessarily sufficient.

What are the risks that equity capital should cover?

Let us recall that probable losses on loans/guarantees must be covered by loan loss provisions. What is left are losses on guarantees that are not probable, but possible. Possible, but not probable, losses should, in principle, be covered by equity capital.

More precisely, all possible losses cannot be covered by equity. A guarantee company trying to cover all risks at 100 % by equity would not be sustainable. In practice "value at risk" (VaR) is often calculated, which represents maximum losses **under the assumption of a 99 % probability**⁶¹. With other words, value at risk is the maximum potential loss under most possible scenarios, to be ex-

ceeded only with a very low probability (1 %). This VaR multiplied by 2 or 3 to take into account the criticism that VaR models are often too optimistic⁶², becomes a measure of necessary equity backing.

Other risks will equally be covered by equity capital. For guarantee companies, especially the risks called "operational" (see 2.4.7 below) and investment risk are involved.

In this manual that cannot handle sophisticated methods, **a simple approach** – and much used in practice – **to determine an appropriate ratio between risks and equity is recommended: it is that of "leverage"**. It is treated in the next section. For the initial capital of a guarantee company see also chapter 3, section 3.3.1.

Which capital can be recognized as "equity"?

As a reminder, equity capital is made up of capital, reserves, retained earnings of previous results, grants and subsidies that have become definitive and – in a limited manner⁶³ – general provisions/general loan-loss reserves⁶⁴ that can serve as safety cushion in case of unforeseen losses. Expected losses must be covered by "provisions" that are treated as charges, reducing equity capital.

Subordinate loans

Can subordinated loans made available by donors be considered as equity capital ?

This manual considers that liabilities that can trigger bankruptcy procedure are not equity. By this criterion, subordinate loans are equity only during a period that they are not repayable.

An essential observation is that guarantee schemes that cannot be based on adequate capitalization are inefficient.

61 Basel Committee on Banking Supervision (2006), n° 346. Basel III toughens the requirements for VaR use, requiring a stressed component, see Basel Committee on Banking Supervision (2011), n° 100

62 cf. for example <http://www.bis.org/speeches/sp101125a.pdf>, p. 13

63 cf. <http://www.bis.org/publ/bcbs128.pdf>, para 49 (x)

64 of the banking type: General banking risk fund, internal security Fund, included in the Tier 2 Capital

Besides the reasons already mentioned, this is also due to the facts that:

- Lenders are becoming larger in size and have doubt about a small institution that would like to act as the protector of their credits.
- An undercapitalized company very quickly gets to the natural limits of its expansion.
- Portfolio formed on too poor equity cannot show sufficient risk diversification features.
- The investment of cash from equity capital should generate a substantial contribution to cover operating costs (ideally, operating costs should be covered totally by investment income, but such a requirement is difficult to fulfill in times of low interest rates).

A recapitalization operation

It can be difficult, en route, to proceed with the recapitalization of a guarantee company.

The Turkish Kredi Garanti Fonu (KGF) company⁶⁵, was founded with a limited capital paid in equal shares by a public-private partnership and donations including that of GTZ.

Having reached the portfolio ceiling, it was necessary to increase the capital. Even though each shareholder was convinced about it, everyone did not have the same ability to contribute, with the consequence that the balance in the shareholding was deeply upset.

Finally, need prevailed and capital was increased with a profound disruption of the internal structure of ownership.

We believe that such a difficulty can be avoided if the initial authorized capital is set at a level higher than the amount that is actually paid up to be in line with needs at the beginning. Cf. also section 3.3.1 in chapter 3 below. As the company grows, additional tranches can be called and raised without interrupting growth.



65 cf. also chapter 1.2 above

2.4.3 Prudent “leverage” between volume of guarantees granted and equity⁶⁶

In the guarantee business, the relationship between equity and the outstanding volume of guarantees issued is called “leverage”. Therefore, a leverage of 5, for example, means that the statement of accounts indicate at a period “T” an outstanding guarantee of 50 and 10 of prudential equity capital.

Well, the actual risk arising from outstanding guarantees depends on several factors:

- the situation of the local economy (inflation, level of interest rates, social, political stability ...);
- the type of guarantee (“loss sharing” or “joint and several with the banker” - see section 2.1.2 above);
- concentration of commitments in a too narrow niche (according to the sector, geographic area, the position of businesses in their life curve ...);
- the “granularity”, i.e. the dispersion of portfolio in a low or high number of customers;
- the intended additionality of the system, the quality of decision making and monitoring;
- the duration of commitments (short term credit, revolving credit or long term investment);
- the amount of counter-guarantee by a third party, if it exists (counter-guarantees reduce the risk of the guarantee company).

To determine the leverage, it is appropriate to take into account actual risk arising from outstanding guarantees.

In practice, in the case of a “loss-sharing” type of guarantee, of balanced concentration indices and of lack of counter-guarantees, a leverage of 5 is often considered appropriate. In the launching phase, the leverage should be lower and progressive (2, 3 x). For a “mature” guarantee scheme, that has reached a well diversified portfolio, a group of European experts estimated a leverage of 7 x⁶⁷ reasonable⁶⁸.

Actually, leverage is a management policy tool that should be adapted case by case. Four observations:

- A first observation is that leverage depends on the general background of health of the target market. Is it very fragile and vulnerable such that it will be necessary to be prudent and careful ... Is the economic situation just below the peak that we need to increase precautionary measures because the decline phase will threaten businesses that received assistance most recently, that have not yet stabilized their situation on a secure level ... ?
- A second reality-based observation indicates that guarantees of significant financial value are more vulnerable **than small ones and, obviously, they can be more destructive of the guarantor’s equity capital A strong “granularity”⁶⁹ of portfolio is always recommended** (see also section 2.4.4 below).

66 cf. also chapter 3, section 3.3.1 below

67 source: BEST (2005) p. 23

68 this consideration is not likely to change with the envisaged introduction of a Leverage ratio by Basel III as a back stop measure as from 2018 (the Basel Committee will test a 3 % capital/risks ratio during 2013 – 2017)

69 In such a portfolio, risks are small compared to the total volume of portfolio, and no risk has such a “large” size (cf. J. Bessis 2010, p. 214)

- **An adequate distribution of portfolio among various economic sectors is equally an advantage.** There was a time that some guarantee schemes were purely mono-sectoral: accessible only to garage owners, to the tourism or the agricultural sector! This suggests that a crisis in such a closed universe was devastating: imagine the printing or photography sector subjected to technological developments, which purely and simply downgrade quite a few operators. Imagine the tourism sector hit during two consecutive years by adverse weather conditions. The reasoning held for the sectors is equally applicable to geographical areas.
- Finally, it is proper to mention the leverage difference that can be accepted depending on whether a company has already existed for 4, 5 years or whether we are dealing with a new business ... whether it is about technologically mature or technologically advanced companies. On this subject see also section 3.3.1 in chapter 3.

2.4.4 Risk diversification⁷⁰

Risk diversification is of the utmost importance, as with any financial institution. A financial institution that would be involved “in only one sector of activity will run the risk of generalized default if the activity financed experiences fails: so, if loans are exclusively granted to fund cotton harvest and the latter suffers disease, all loans will be simultaneously non-performing. The save to this type of risk is found in portfolio diversification” ⁷¹.

More generally, even if a guarantee scheme is involved in several sectors, it may nonetheless be subject to too much “covariant” risk, that is to say risks that affect a great number of borrowers at the same time⁷² (see also section 2.5 below). Look at the example of a guarantee company that granted 40 % of its volume of guarantees to peasant farmers in the same geographical area, subject to the same climatic conditions, affected by drought:

Risks	Probability of loss	Portfolio	Expected loss
Guarantees granted			
a) Outside agriculture	5 %	6,000,000	300,000
b) Agricultural sector	90 %	4,000,000	3,600,000
Financial investments	3 %	5,000,000	150,000
Total			4,050,000

Available risk cover tools	Volumes
a) Loan loss provisions	1,000,000
b) Equity capital	2,000,000
c) Counter-guarantees	1,000,000
Total	4,000,000

70 Cf. also chapter 3.5.1 below

71 translated from: Taillefer (1996), p. 208

72 Deelen & Molenaar (2004), p. 34

In this example, the total amount of expected loss would exceed the total risk cover, due to a high probability of losses on guarantees granted in one sector alone (90 % in the agricultural sector). The guarantee company may become insolvent.

The example above is rather schematic because it implies a high risk in the agricultural sector alone. But in the case of a disaster like drought, other sectors might be affected as well, for example that of commerce exposed to risk of reduction in turnover, as well as craft industry, affected by drop in orders.

In practice, total risk control by **setting up a maximum percentage for guarantees in high covariant risk sectors** has become good practice in the financial sector. For example, “successful rural credit unions ... typically cap their agricultural lending at 10 – 25 percent of their portfolio”⁷³. Section 2.4.8 will treat this aspect in greater detail within the framework of a total risk control approach.

Apart from a limitation of high-risk sectors, an effective diversification requires the limitation of the shares of single risks in the total portfolio and setting a maximum percentage of a single risk in relation to equity capital in the guarantee scheme⁷⁴.

If sufficient risk diversification does not seem possible, the guarantee scheme is probably too small or established on too narrow a base! Cf. chapter 3.3.

2.4.5 Limiting the number of “big borrowers”

Prudential regulation normally limits the number of “big borrowers” that are either the same person (or company) or a group of persons (or companies) who have related interests.

In many countries, banking law distinguishes big risks (allowed but requiring a special reporting) and unacceptable risks (over 25 % of equity capital). In the sphere of guarantee companies, we propose that the maximum guarantee per borrower does not exceed 5 % of equity.

2.4.6 Good cash management to avoid lack of liquidity in case of unexpected compensations

Risk management also requires good cash management, to avoid illiquidity due to unexpected calls for compensation by partner credit establishments. This important component of risk management will be treated in-depth in section 2.8 below.

A timely payment following a guarantee claim is paramount. For financial institutions, it is a special advantage to work with an external guarantor and not to have to wait till the end of legal recovery proceedings.

2.4.7 “Operational risk” control, including safeguards against corruption

“Operational risk” is a generic term for referring to risk of losses due to errors or human offences or system malfunctions. It is proper to distinguish risks

1. of transaction, for example, due to data recording;
2. of fraud and bribery;
3. of equipment, for example due to computer systems malfunction or outbreak of fire;
4. legal and litigation risks.

73 from CHRISTEN and PEARCE (2005), p. 14

74 See for example: STASCHEN (2003), p. 19 and 28

The most important measure is the introduction of a functional internal control system⁷⁵.

- The **four-eyes principle**, characteristic of credit institutions, equally deserves to be applied to all legal obligations of guarantee schemes. Guarantee agreements must indicate that they are legally valid only if they bear two signatures in accordance with the statutes. This principle reduces the likelihood of errors and corruption.
- **Since guarantee schemes are particularly vulnerable to corruption, decisions to grant a guarantee must not be taken by individuals, but by Committees working in consensus and from which people who have a personal interest have withdrawn.**
- A modern “**Management Information System**” (MIS) will facilitate management risks and will periodically inform management about essential indicators such as:
 - loans guaranteed since the previous report ,
 - the total amount of guarantees outstanding and their breakdown according to different criteria (sectors, age of the businesses, objective and type of loan guaranteed, name of the lending institution ...)
 - outstanding doubtful guarantees and loan loss provisions set up,
 - loss rates⁷⁶
 - definitive losses net of recoveries,
 - proceeds from financial investment.

For guarantee companies that calculate Value at risk (VaR), that is to say possible maximum losses under the assumption of a 99 % probability to determine equity capital required, sophisticated MISs (management information systems) equally establish the “Value at Risk” of different activities.

It is the task of internal control to ensure that information which enters into the MIS is reliable and as complete as possible. Careful verification is strongly recommended.

- Internal control should be part of risk management. One question is if it can prove advantageous to out-source this important service to an independent and specialized firm. For guarantee schemes, which normally have very limited personnel – especially during the launching phase – such out-sourcing will often be preferable. It may however not be permitted by prudential regulation.
 - To reduce the risk of employees colluding with credit institutions (for example, in order to guarantee loans already granted to borrowers in difficulty), regular rotation of employees is practiced in some institutions⁷⁷.
 - In some cultural environments, mandatory deposit of a sum of money may be required for holders of high-risk fraud and corruption positions⁷⁸.
- Operational risk can equally arise from the corruption of employees or directors. They can induce their institutions to guarantee**
- loans already granted for which the credit institution no longer wants to bear the risk alone
 - credits to borrowers who will probably not be able repay the loan.

75 cf. for example Campion (2000)

76 although designed for microfinance institutions it is recommended, for in-depth, to see the excellent

77 See for example CAMPION (2000), p. 45

78 see for example op. cit., p. 45

What precautions can a guarantee scheme take against such risks?

- The best precaution is a good analysis of the risk of every new guarantee before it is granted, and taking decision in a professional committee.
- For portfolio guarantees that are not granted individually, it is advised to apply a lower rate of cover, perhaps 50 %.
- Offering incentives – for example lower guarantee fees - to credit institutions which do not exceed a reasonable and sustainable loss rate.
- According to a World Bank study, 10 % of the guarantee schemes monitored require higher fees from credit institutions having high rates of nonperforming loans⁷⁹.

“Moral hazard” can equally come from an abuse of the system by lending institutions which benefit from external guarantee for not having performed their analysis or monitoring duty as real professionals, and which too systematically entrust the credit documents to rating agencies.

To minimize this risk, it is necessary to ensure that the credit institution actually bears part of the risk (cf. chapter 2.1 above). In addition, Ian Davies advises the establishment of a Code of Ethics, following the example of the Korean “Credit Guarantee Fund Code of Ethics”⁸⁰.

For **technical and computer risks**, some institutions appoint responsible persons among their employees to take useful measures. Generally, 100 % operational risk prevention may be too costly. A useful method to improve understanding of the magnitude of threats is scenario analysis. Scenarios, if properly organized, can provide a better estimate of the likelihood of certain risks. Some insurance companies and audit firms offer scenario analysis seminars.

The strongest **legal risks** are caused by disputes with credit institutions in case of non-payment of a loss situation. This subject is treated in section 2.8.3 below. We recommend a very clear definition of the conditions that trigger the obligation of the guarantor to compensate the lender. Practitioners know that there will always be cases of doubt. The trap to avoid is to fall into protracted and costly litigations. It is clearly necessary to avoid pretexts allowing a guarantor to contest his liability to pay compensation, which indeed in the very short term would mean discredit on his moral sense and financial function.

In some countries, prudential control authorities require backing of operational risk – in addition to credit risk – by equity capital, as the Basel Accords do: its prudential capital requirement is 15 % of the average 3-year net income in interest and commissions.

2.4.8 Introducing a total risk management system at the Head office⁸¹

The following Excel table provides a simplified example comparing expected losses (835,000, cell D 8) and total risk cover of a guarantee company (3,500,000, cell C 14):

79 BECK et al. (2008), p. 19

80 op. cit. p. 115

81 This more technical section can be omitted by the fast reader without prejudice to the understanding of the next sections

	A	B	C	D
1	Risks of losses	Probability of loss	Volume of risks	Expected losses
2	On guarantees extended			
3	■ Covariant risk sectors	10 %	3,000,000	300,000
4	■ Trade	5 %	500,000	25,000
5	■ Crafts industry	6 %	3,500,000	210,000
6	■ Others	7 %	3,000,000	210,000
7	Financial investments	3 %	3,000,000	90,000
8	Total expected losses			835,000
9				
10	Risk cover capacity		Volume of risk cover	
11	Loan loss provisions		1,000,000	
12	Equity		1,500,000	
13	Counter-guarantees		1,000,000	
14	Total risk cover capacity		3,500,000	

It is surely a simplified example. Some types of software allow more sophisticated scenarios Their utilization in practice is recommended and can be supported by technical cooperation under certain conditions.

Scenarios can equally provide an answer to the question (see also section 2.4.4. above):

How can a guarantee company know up to what percentage of its portfolio it can grant guarantees in a sector or geographic area with high covariant risk ?

The response can be found through “stress tests” which⁸²

- first simulate probabilities of high losses in a sector, for example, due to a disaster
- then observes the consequences of this event on other sectors, through correlation tables
- calculate total expected losses and
- compare total expected losses with total risk cover capacity.

82 See for example Frisch, C. and Klingeler, R. (2007), p. 1346

Without access to professional software, a first impression of the procedure can nevertheless be made gained by using two Excel spreadsheets as follows:

- a) Establish a primary main spreadsheet following the example of the spreadsheet above, based on available equity, loan loss provisions set up and – if applicable - counter-guarantees (risk cover capacity), outstanding existing guarantees and realistic estimates of probabilities of loss in normal times.
- b) Establish a second spreadsheet of correlations (“correlations matrix”) of the main relevant sectors based on estimates or time series of the past, if available (see example below).
- c) Insert a loss probability of 0.9 = 90 % (corresponding to a dramatic event like drought) in the appropriate cell of the spreadsheet (B 3 in the example above).
- d) Infer the probabilities of losses, in case of a dramatic event, for the other sectors weighted by the respective correlation rates (from the correlations matrix), and insert these increased probabilities in column B of the main spreadsheet.

- e) Check if total expected losses in cell D 8 of the main spreadsheet are still covered by total risk cover capacity (cell C 14).
- f) If total risk cover capacity (cell C 14) exceeds total expected losses in cell D8, lower the amount of the volume of guarantees in the strong covariant risk sectors of the principal spreadsheet (cell C 3) until the risk cover at least equals expected losses The share of the cell C 3 amount in total guarantees corresponds to the allowable percentage.

In more detail, with examples (the hurried reader can skip the following passages):

ad b) Correlations matrix

A correlations matrix shows the correlation observed in the past (or estimated) between the changes of default rates in the different sectors. A correlation of 0 indicates no correlation (no influence/repercussion) at all, whereas a correlation of 1 corresponds to a perfect association. Correlations between 0 and 1 indicate imperfect associations. Example: If an increase of default rates in the agricultural sector by 20 % is followed by an increase of defaults in the trade sector by 10 %, the correlation would be 0.5 .

The following spreadsheet gives a very simple example of a correlation matrix:

	A	B	C	D	E
1		Agriculture	Trade	Craft industry	Others
2	Agriculture	1	0.5	0.4	0.3
3	Trade	0.5	1	0.6	0.2
4	Craft industry	0.4	0.6	1	0.1
4	Others	0.3	0.2	0.1	1

In the absence of time series of the past that help to deduce such correlations, Central Bank or Statistical Office estimates could be used. Statistics from a neighbouring country can also be helpful if structures are similar. - The figures in the spreadsheet above are fictitious and only serve as an example.

In case more precision is aimed at and figures are available, one could equally - unlike the correlations matrix above - establish different correlations according to causality direction, for example a correlation of 0.4 for the impact of default changes in the agricultural sector on the crafts industry, and of 0.2 for the effects in the opposite direction. Such a sophisticated approach would be more realistic, but is probably too ambitious for several countries.

ad c)

Hypothesis: The sector with high covariance risk (for example the agricultural sector) incurs a loss probability of 0.9 (90 %) due to a catastrophe. In the concrete case at hand, the “normal” loss probability of 10 % would have to be multiplied by nine.

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ad d)

The loss probabilities of the other sectors would be increased in a weighted manner, with the correlation rates serving as weighting factors. For example, on the basis of the correlations matrix above the loss probability in the trade sector would be multiplied by 4.5 (= 9 times 0.5). That is to say, the loss probability in this sector would in-

crease, too, but to a lesser extent because weighted by the default correlation rate of the agricultural sector with the trade sector.

Following the above hypotheses, the principal spreadsheet above would have to be adapted as follows:

	A	B	C	D
1	Risks of losses	Probability of loss	Volume of risks	Expected losses
2	On guarantees extended			
3	■ Covariant risk sectors	90 %	3,000,000	2,700,000
4	■ Trade	22.50 %	500,000	112,500
5	■ Crafts industry	21.60 %	3,500,000	756,000
6	■ Others	18.90 %	3,000,000	567,000
7	Financial investments	3 %	3,000,000	90,000
8	Total expected losses			4,225,500
9				
10	Risk cover capacity		Volume of risk cover	
11	Loan loss provisions		1,000,000	
12	Equity		1,500,000	
13	Counter-guarantees		1,000,000	
14	Total risk cover capacity		3,500,000	

In the example selected in the spreadsheet above, no increase of probability of loss has been estimated for financial investments, which may be too simplistic in practice.

ad e) and f)

In the example, total loss (4,225,000) exceeds total risk cover capacity (3,500,000). In order for risk cover capacity to cover total loss, it would be necessary to lower the

share of guarantees extended in the strong covariant risk sector to approximately 19 % of the total portfolio of guarantees, as shown in the following spreadsheet:

	A	B	C	D
1	Risks of losses	Probability of loss	Volume of risks	Expected losses
2	On guarantees extended			
3	■ Covariant risk sectors	90 %	1,900,000	1,710,000
4	■ Trade	22.50 %	1,200,000	270,000
5	■ Crafts industry	21.60 %	3,500,000	756,000
6	■ Others	18.90 %	3,500,000	661,500
7	Financial investments	3 %	3,000,000	90,000
8	Total expected losses			3,487,500
9				
10	Risk cover capacity		Volume of risk cover	
11	Loan loss provisions		1,000,000	
12	Equity		1,500,000	
13	Counter-guarantees		1,000,000	
14	Total risk cover capacity		3,500,000	

This example equally shows that this manual cannot indicate, à priori, any maximum percentage for high-risk covariant sectors. This percentage depends above all on the risk cover capacity in the specific case, especially on equity.

But it is strongly recommended to set a percentage limiting the maximum share of covariant high-risk sectors, unless the risk in these sectors cannot be reduced through derivatives or insurance.

2.5 Limitation of risks linked to the agricultural sector

2.5.1 Risks and guarantees specific to the agriculture of developing countries

An overview on agricultural finance

Except Agricultural Development Banks, banks are reluctant or have for a long time hesitated on financing agricultural activities. This is particularly true of developing countries. Several reasons explain this prudence:

- banks are born in towns and their primary objective was to fund trade, then, later, industry. For a long time agricultural business was strange to them,
- to take decisions, bankers rely on corporate accounts and take diverse collaterals. But, generally, peasants do not keep accounts, at least according to usually accepted standards and they cannot always provide the required collateral,
- small farmers are numerous but their financial needs are mostly modest. The multiplication of small loans increases management costs and they are hardly of interest to traditional banks,
- finally, return on equity invested in agriculture is rather low in many countries, often deferred and always unpredictable. For the lender, the risk of loss is therefore never negligible and it can even be very high.
- There is a real reciprocal distrust between the banker and the farmer: the first is afraid of default and the second considers that the Bank does not understand him/her⁸³.

If commercial banks are always reluctant to finance small farmers, other financial structures like solidarity type banks, decentralized financial systems or MFI strive to meet this challenge. They have generally succeeded in reducing the first three handicaps mentioned above: they are established in villages, they know the needs of the farmers, their revenues and the collaterals that they can offer. Finally, they have reduced their management costs to the minimum thus making it possible to grant small loans. Nevertheless, they still encounter the problem of the risk of default with its specificities peculiar to agriculture in general and agriculture in the developing countries in particular. However, the profile of their resources does not allow them to fund productive equipment in a sufficient term and their conditions for access to credit therefore do not integrate agricultural constraints.

2.5.2 Different types of risks inherent in agriculture

Individual risks can be attributed to different causes:

- Possible delays in the work (in countries with short wet seasons, any lateness in planting crops has serious consequences on yield)
- Unexpected family events (illness, marriage, death ...) that harm the smooth running of agricultural work or cause extraordinary expenses,
- Local weather or health hazards (storm, damage caused by pests, epidemics ...),
- Lack of control of distribution channels on the part of small producers.

83 Cf Dialogue à Deux Voix, Ouagadougou Seminar, January 2003, SOS Faim, SIDI, Inter-Réseaux

The most serious co-variant risks are caused mainly by:

- General and widespread weather hazards (drought, excess water ...),
- Strong and prolonged decrease in sales price, notably export,
- Given the increasing number and severity of problems in developing countries, banks that fund agriculture seek to surround themselves with maximum caution,
- The choice of collateral required will vary according national laws, land ownership regimes, objects funded and lenders,
- Thus pledge is the collateral preferred by users and other individual lenders, but banks equally use it,
- Mortgage is rarely used. Banks rather require group guarantees (5 persons in Bangladesh or the whole village organization in West Africa),
- For short term loans that finance crops often marketed by a single organization, delegation of payment is the rule (as in Mali with the former CMDT or Benin with SONAPRA, which buy cotton).

Modern methods of credit risk management in the agricultural sector⁸⁴ have helped to reduce distrust towards financing agriculture⁸⁵.

It will be recalled that **external guarantees can only fill a gap in collateral, never in profitability**. In the agricultural sector, external guarantees cannot compensate for lack of revenue stability due to weather hazards either, etc. For the latter, other instruments (especially insurance) are applied, if available.

Thereafter it is proper to verify what difficulties are surmountable and can really accelerate productivity growth of small farms:

- **The need for liquidity to bridge the gap** between planting and harvesting. If this need is properly covered by an accessible credit, it is likely that operating conditions will be improved.
- **Financing associations that allow** centralization of crops and their sale in regional markets. This centralization is conducive to adding value through small processing in the production or its packaging.
- **Small individual (equipment) or group investments** (irrigation, pump ...) including their maintenance over a limited period.
- **Agriculture in the wider sense** of rural activities by making room for financing tools of small trade and craft industry, to further organize the complementary development of the village community.

84 To be consulted among others: GIEHLER, KARLUCK and SEIBEL (2005), p. 10 s., KLEIN et al. (1999), p. 49 s., GIZ (2011) p. 34

85 "The issue is ... not whether rural and agricultural finance face particular problems, but that these problems are surmountable and have in fact been solved by a number of institutions. These institutions have developed a range of risk management strategies for the financing of agricultural and other rural investments", GIEHLER (2005), p. 11

Therefore, there is room for guarantee companies in this sector and under this economic context, on condition that the target be chosen judiciously, that the risk-sharing of this sector in the overall portfolio of

guarantees be strictly limited (see sections 2.3.4 and 2.3.8 above) and that the guarantor relies on lenders that are well established in this environment. Microfinance⁸⁶ institutions and guarantee companies can become effective allies.

Rural financing assured by a guarantee scheme in Mali

The AOPP in Mali (Association des Organisations professionnelles et paysannes du Mali) is a federation of 170 organizations, representing nearly one million people in the country. Among its multiple activities, the AOPP works with small cooperatives to produce and commercialize certified seeds, in a food sovereignty approach.

After the support of foreign aid that helped in understanding the different constraints of this sector, it is now the Malian Solidarity Bank (BMS-SA) that is financing the sector through a guarantee fund set up after and as a remnant of a support project (Oxfam-Solidarité Belgique). The complete cycle extending over a period of 17 months, is an appropriate arrangement for risk cover that can cover both cycles while ensuring that BMS covers 50 % of the risk ...

2.5.3 Innovative agricultural financing methods and guarantee schemes

The search for better methods of financing the private economy targets, among others, value chains. Looking at sectors - in the sense of value chains - rather than individual units, synergies are sought. For example, instead of improving the financing of farmers and processing companies in the soybean sector, optimal financing of a whole value chain, including providers of related services⁸⁷, is being sought. However, the management of storage depots for agricultural products is fraught with problems in a lot of countries (damage, theft, fraud, failed speculation). Warehouse receipts (warrants) can represent – under the condition of appropriate legislation and the existence of performance bonds – collateral acceptable to banks⁸⁸.

Guarantee companies looking for new income-generating activities and which do not yet have too much risk in the agricultural sector could consider managing warehouses themselves. It would be another way to “produce” collaterals (warrants) acceptable to Banks.

Agricultural organizations such as service cooperatives, associations and peasant communities need substantial funds to ensure crops on the one hand and to perform marketing activities in common, on the other hand. Similarly, micro finance institutions that provide credits to small producers organized in rural areas or not.

86 See for example CHRISTEN and PEARCE (2005)

87 For example Miehlbradt & McVay (2006), p. 62

88 For example exemple Lacroix & Varangis (1996), p. 36 s.a

Ensuring the financial operations of farmers' and agricultural organizations in Latin America, the case of FOGAL:

The Latin-American Guarantee Fund (FOGAL), created by the Belgian Organisation of International Solidarity SOS Faim, is an institution specialized in the provision of guarantees to coffee, cocoa, banana and quinoa cooperatives... and rural micro finance institutions for them to have access, through an intermediary guarantee, to loans from private Bank and Government and/or other international organizations that provide credit, among which many are European.

FOGAL provides institutional and not individual guarantees, ranging from 10,000 USD to 200,000 USD.

FOGAL stimulates a set of guarantees: agricultural organizations can pledge annual harvest. They also have land and buildings that can serve as mortgage. In combination with guarantees provided by FOGAL, they form a portfolio of guarantees that favours a better negotiation with Banks (interest rates and multiplier).

Observed effects of the FOGAL agricultural guarantee:

On operation: (1) Increase in the resources of the OP, (2) Improving conditions for obtaining financing, (3) Improvement in the interest rates of credits and (4) Longer-term contracts

On strategy: (1) Establishing formal/commercial OP relationships with Banks or other financial entities, often for the first time, aimed at long-term financing strategy, (2) Diversification of sources of funds, improving their risk profile (no longer depending on a sole source of funding or cycle of aid).

2.6 Adapted guarantee fees

If the guarantor's activity takes on a promotional function, the financial nature of guarantee institutions and the strong will not to make them "subsidy pumps" require that risks be paid for. Simply, the price of risk and the cost of service must aim at the long term sustainability of the institution.

The remuneration of the guarantor may take different forms: (1) application appraisal fee, which, most often, is paid for only if a guarantee is actually granted and (2) guarantee fee that remunerates the risk and appears under various terms:

- expressed in x % per annum on the guarantee amount on anniversary dates of the guarantee extension
- payable either by annual fractions (the procedure is more complex and more expensive) or in block at the time of the issuance (the amount to be paid appears heavier but it can be taken from the credit amount)
- payable by the borrower, which is normal because he is the one that receives the credit access service. But certain schemes put it at the lender's charge: frequently the interest rate on the loan will increase as a consequence.
- The guarantee fee can be differentiated between credit institutions that are shareholders of the guarantee company, and others, thus ensuring a compensation for a closer partnership
- Differentiation can be made according to guarantee products: a working capital transaction or an investment loan or a technical guarantee; a start-up loan and a credit to an existing business ...
- It can be calculated on the guarantee amount or on the credit amount ...

These points are modalities. But the central question remains “what percentage must be applied?”

- Too low fees do not remunerate the risk. They simply put the survivability of the guarantee institution at stake.
- On the other hand, “remuneration of risk should not be too high because, in this sense, it will attract into the portfolio only high-risk cases and discourage debtors with a “standard” risk grade. There would be a perverse effect that might push the cost up still higher. We relativize: ‘too high’ is a fluctuating concept, which does not have the same meaning in an economy with a 3 % inflation rate and 8 % interest rate or an economy with a 0.5 % inflation rate and a credit commercial cost of 5.5 %”⁸⁹.

Some guarantee schemes fear that high fees, in addition to high interest rates in the case of low-rated borrowers, may result in “adverse selection” (excess high risk in their portfolios) and distort their portfolios towards high risk.

The real bases for setting the fee depend on:

- the general risk situation in the country (what risk premium rate do Banks include in their rates and do they have profitable businesses?) It is useful to match their actual credit appetite and the rate of loss that they are suffering.
- the additionality that one wishes to give to the guarantee scheme. If we try to attract into credit professional niches that are most risky, we will provide for a strong fee. If you have more limited ambitions, you can adjust to a more accessible level. In countries with less mature economy, it is common for Banks to reject applications not because the projects represent a strong intrinsic risk but due to mere lack of collaterals. In this case, there is a nice opening for a guarantee scheme.
- the possible support that the scheme receives from outside (counter-guarantee or subsidy of the premium).

Guarantee fee in the first approximation.

A recommendable approach for a new system, which lacks a historic reference, is

- revenues from financial investments cover operating costs,
- the fees cover the ultimate net loss probability, taking into account the social function and the not-for-profit character of a guarantee scheme.

In its simple and historic form the fee is linear. It is x % of the outstanding guarantee and per annum. Mutual companies generally apply this method that is contained in their philosophy: the good obligor pays for the not so good one since there is solidarity between them.

Other guarantee schemes modulate the fee according to individual risk born on each customer and, if necessary, the scoring or “rating” of the beneficiary.

A solution was also sought by means of subsidization of the fee: calculated at a level with a small margin above the survivability of the institution, it is only partially borne by the borrower and, what is left over, is compensated by a State subsidy or a donor agency. This is a cheap and efficient support system for a start-up from scratch.

Linear or variable fees?

- In Turkey, the Kredi Garanti Fonu applies an identical linear fee mechanism for each customer.
- Finnvera, in Finland, calculates fee based on the default probability of each case⁹⁰.
- In Japan, the reform of April 2006 introduced a fee calculated on the degree of risk by type of portfolio aimed at stopping the financial bleeding associated with the deep crisis of 1998. The system was expected to enable Credit Guarantee Corporations to offer lower fee rates to lower credit risks and to expand the opportunity for higher credit risks SMEs to use the guarantee programme.
- The GARI fund (Fonds de Garantie des Investissements Privés en Afrique de l'Ouest; Private Investments Guarantee Fund in West Africa), charges 2 % for shareholder financial institutions and 3 % for non shareholder institutions.
- In the Czech Republic, the guarantee scheme, managed by a development Bank, operates an individual commercial risk approach but the government subsidizes the part exceeding 0.5 %/year, percentage borne solely by the borrower.

Fees related to the product

In Austria, the public company Austria Wirtschaftsservice is in charge of guarantees. When a new product is designed, the basis for its rate of cover and its pricing depend on the answer to the question: “does this guarantee product have a market appeal or a promotional function?”

The answer to this question must be clear.

- If the product is commercial, the conditions will conform to the market: the level of protection should be stimulating so that lenders can use it, but the price must be in line with the risk borne by the client.
- If the product is aimed at the promotion of an SME in difficulty to access particular credits, the degree of cover should have to be higher and the rate slightly lower than the probability of loss.

These principles will have to comply with European competition and State aid regulations in force and accepted by the shareholder State, which knows in advance that a subsidy will be necessary.

A World Bank study (World Bank 2010, p. 16) has observed basic (standardized) fee rates of a “benchmark group”⁹¹ ranging from 0,8 % to 2,3 % p.a. Some of these rates are

adapted according to risk, to coverage ratios and/or loan amounts.

90 Douette (2003), p. 61 et 115

91 The “benchmark group” was composed of: SLFP (Canada), Chile’s FOGAPE, Colombia’s Fondo Nacional de Garantías, France’s OSEO, Hungary’s Garantiqa, India’s CGTMSE, Korea’s KODIT, the Netherlands’ BMKB, Romania’s National Credit Guarantee Fund for SMEs, Taiwan’s SMEG, and the US SBA

2.7 Shareholders that really have an interest to succeed

A number of guarantee funds or companies have failed due to shareholders that did not show enough interest in the long term success of the institution.

In many countries, guarantee schemes pursue a non-profit making objective, even if they have a normal commercial status. Non-profit making does not mean that they are forbidden or that profit-making is being denied them. It means that if there is profit at the end of the year, it is not distributed to the shareholders. Similarly the latter cannot benefit from an increase in value of the equity at the time they would be withdrawing: the surplus value belongs to the company or, if this company is being liquidated, it redounds to another micro or small enterprise promotion establishment.

A dilemma is therefore created by the non distribution of dividends to shareholders. The way out of this dilemma is to design the shareholder structure in such a way that shareholders really become interested in the success of the scheme despite the lack of financial return on investment.

There are several ways to achieve this goal:

- Establishing a mutualist shareholder structure,
- Winning the interest of shareholders through other benefits (e.g. for shareholder banks the development of their credit portfolio with a better contained risk, the acquisition of a new clientele; for SMME associations, proposing a new service to members, closer integration on the financial chessboard ...)
- Integration into a professional financial institution.



2.7.1 Establishing a mutualist structure

Members (often small business owners) of a mutual guarantee company, have a stake in the sustainability of the mutualist company, so that it can help them in time

of need. They are called upon to underwrite a small portion of the capital when they use the guarantee. Cf. also section 3.1.4 below.

Mutual companies in Portugal

In 1994, Portugal, anxious to promote its small businesses after a long period of political isolation and after having entered the European Union, decided to have a “mutual” and integrated guarantee system.

It appeared however impossible to ask small business owners to subscribe to capital before the guarantee instrument had shown evidence of its usefulness and effectiveness. The State then decided to buy directly the large majority of the capital, mainly through its promotion agency IAPMEI. Subsequently, each time a businessperson needed a guarantee, he/she bought some public sector shares... This went on until the scheme obtained a majority of private mutual capital.

Presently, the system is very dynamic and is fast growing. In 2001, 2006 and 2010, the outstanding commitments amounted respectively to 96.4 - 346 – and 3,762 Million Euro.

The scheme is structured as a group, headed by a holding company that manages the public counter-guarantee and commercially animates the group. It keeps the accounts, statistics and maintains relations with the banking supervisor.

At the root, there are operating companies organized regionally, which provide contact with lenders and SMEs that take and manage commitments.

After 6 years as a pilot project and 10 years as a full-fledged functioning system, the SPGM mutual network has proven its usefulness, its efficiency and its survivability.

What does mutualism mean in Salvador?

Mutualism is not only a way of organizing capital and shareholders. It is above all a management philosophy. In Salvador, mutual companies have been inspired by Spain.

Shareholders are divided into two groups:

- the “socios participes” are entrepreneurs that use guarantee and become its shareholders. They are the majority.
- the “socios protectores” are entities that have interest in a thriving economy and which, to contribute to it, support mutual guarantee companies with a capital contribution. These shareholders cannot hold more than 50 % of the capital and they may not solicit guarantee services. They are public authorities, financial establishments, and federations of businesses ...

Entrepreneurs participate in General Assembly meetings and can become members of the Board of Directors or of the Commitments Committee. Decision is taken by “the peers”, who themselves have a good knowledge of the constraints and particular opportunities of SMEs.

Business-managers are under pressure to render a real service to their colleagues whose paid-in capital they are in charge of. They will therefore take informed decisions with rate of loss contained.

Finally, they are structured by local or regional Decision Committees to keep the closest watch on the environment where their partners operate.

2.7.2 Arouse shareholders' interest through other benefits

When banks show interest in credit to SMEs and become shareholders in guarantee companies, even without any perspective of dividends, they are really seeking an

expansion of their portfolio and business. They also seek protection of their loans while having “one foot” in the management of the guarantee instrument. Obviously, the bank has no voting right if it happens that one of its files comes up for deliberation.

Shareholder Banks?

In Egypt, the Credit Guarantee Company was founded in 1991 in the form of public limited company. Its shareholding is made up of nine Banks and one Insurance Company.

The equity capital, of which issued capital is 0.6 million Euros, amounted to 32 million Euros taking into account reserves and donations from USID, FNDP, and EU and an Italian donor. They are henceforth supporting a portfolio of guarantees of 90 million Euros.

In other types, associations and Chambers of Commerce/ Crafts are majority shareholders. They seek service for their members, whose interests they represent.

Chambers of Commerce, Industry and Craft Industry shareholders?

In Germany, companies are bound to join the Chamber that represents their business. In turn, the latter participates in the capital of guarantee Banks called “Bürgschaftsbanken”.

The Chambers of Commerce play a complementary role of experts: they give an informed opinion on guarantee applications through their knowledge of particular situations and guide decision making bodies. They intervene if there is need for rescuing or counseling a guaranteed entrepreneur.

2.7.3 Integration into a professional financial institution

If a guarantee scheme is part of a range of services of a specialized financial institution of the “development

Bank” type, that latter will make its expertise available to the business.

A development bank in the service of guarantee?

In the Czech Republic, the Guarantee and Development Bank CMZRB⁹², is a full service and mixed type financial institution: its shareholding is formed by state Ministries and banks. The Government charged this institution with the implementation of guarantees for SMEs and granted “specialized guarantee funds according priority public objectives”. This Bank, subjected to the vigilance of the bank supervisor, manages guarantee programmes and has been able to benefit from computer systems developed to make very sophisticated techniques available, to the benefit of the guaranteed business.

So we see that there are opportunities to structure a stable shareholding, despite an objectively difficult context.

In the vast majority of the developing economies, the State or public authorities at large or external donors should be involved in developing the programme, provided they know what are the ins and outs and they are aware of the benefits to expect for the company they are in charge of. But as a very general rule, it is necessary to associate it with private initiative in order to provide dynamism and professionalism. Public sector operating rules may be too rigid to put up with a financial mechanism requiring flexibility and speed.

If the public sector is alone, it should, in our opinion, entrust a specialized committee of experts with the reins of analysis and decision-making on guarantee applications (The Commitment Committee).

2.8 Conservative financial investments, liquidity management

2.8.1 Financial investments

- On the one hand, equity capital paid into the institution is not intended for distribution of dividends.
- On the other hand, between receipt of guarantee fees and some outflow of liquidity to compensate credit losses, a layer of liquidity is formed that is available for financial investment.
- The policy of investing liquid assets is therefore crucial for the good functioning of guarantee schemes because it is a source of income.
- As credit losses are unpredictable, investments must be easy to liquidate.
- It is therefore proper to put into effect the “easy to liquidate” requirement and balance this objective with that of getting a return on investment.
- Partner credit institutions will be quite willing to give their advice with regard to financial investments. Beware, however, of investing in securities issued by a partner establishment or of interest-bearing accounts with them: such investments can cause dangerous concentrations of risk. In fact, a partner credit establishment in jeopardy as a result of high non-performing loans can cause double damage to a guarantee company: high compensations and loss of value of investments would cumulate. The recommendation of security and diversification therefore also holds, to a certain extent, for financial investments.
- A “rule of thumb” is that financial investment income should be able to cover a substantial part (ideally 100 %) of operating costs of a guarantee company in order to release income from operating activities to cover the risks.

This principle calls, once more, for a sufficient capitalization of the company.

The importance of financial investments in management

The Turkish Kredi Garanti Fonu underwent a severe crisis in the year of 2001 during which the Turkish GDP contracted by 8.5 % and the average interest rate on financial markets peaked at 93.5 %.

The company had to contract its business of guarantees extension from 10 million in 2000 to 4 million in 2001. But a sound policy of financial investment, notably in foreign currencies, helped to more than double the financial income.

With the help of this income, KGF was able to overcome the difficult situation and resumed growth that led it to develop leverage 6 times its equity capital in 2005.

Persons responsible say that that period was a remarkable learning phase.

2.8.2 Managing liquid assets

The financial environment

The rational approach to the management of the liquid assets of financial institutions depends to a large extent on the existence and functioning of money markets (one important function of which is the evening out of liquid assets between financial institutions). The following recommendations are meant especially for companies and guarantee funds in a developing country with an imperfect money market where mismanagement of liquidity can easily jeopardize the company or guarantee fund.

For companies and guarantee funds a good rule to follow is to always provide for sufficient immediately liquid assets for current expenses (such as staff salaries and

electrical currency) and for covering individual loan loss provisions, because provisions show probable expenditure for claims settlement.



It is also proper to have a management tool that brings together all cash deficits, and their cover. However, for guarantee companies most expenses are not easily predictable.

Here is a fictitious example of a dashboard of a guarantee company:

	Base	Weighting	Payable immediately	Due in 1 month	Due in 2 months	Due in 3 months
Commitments						
Guarantee calls by credit institutions	150	1	150	0	0	0
Provisioned outstanding guarantees	400	0.15 *	60	60	60	60
Non provisioned guarantees	4,000	0.005 *	20	20	20	20
Current expenditure	48	1 *	48	48	48	48
Other commitments	20	1 *	20	20	20	20
Sum of payable commitments						148
			298	148	148	
Cover by						
Cash and current bank accounts	820	1	820	578.8	487.6	396.4
Interest on financial investments	12,000**	0.004 *	48	48	48	48
Fees received	4,400***	0.002*	8.8	8.8	8.8	8.8
Total cover			876.8	635.6	544.4	453.2
Surplus/Deficit			+ 578.8	+ 487.6	+ 396.4	+ 305.2

Comments:

* weighting is made for one month, for example: $400 \times 0.15 = 60$

** total outstanding financial investments

*** total outstanding guarantees

In this simplified dashboard,

Total cover \div sum of payable commitments = surplus in period $t =$ cash + current bank accounts in period $t + 1$

The weighting percentages in the table above are purely an example. In the case of loan loss provisions, percentages can be based on instructions by the supervisor.

The table is simplified because it should cover a longer period of time. In practice, there should be more columns (amounts due in 6, 9 and 12 months).

The management of liquid assets can be based on the supervisory authority's instructions. Prudential regulation can provide that liquid assets (for example liquid investments and cash) must always exceed current liabilities and commitments due. The dashboard table above can be used to help in complying with this regulation.

2.9 Monitoring, restructuring and default management procedures; precise definition of loss event

2.9.1 Monitoring

General conditions of the guarantee (or framework contract between the guarantor and the credit institution) stipulate the period (at least quarterly) and the content of written reports that the lender sends to the guarantor.

The content should provide two types of clarification:

- Do the lender and the guarantor have the same database and do they record the same guaranteed credits? Any discrepancy due to a human error in recording or resulting from advance loan repayment to the lender that was not brought to the guarantor's knowledge should be avoided. This is essential for absence of confusion and accuracy of the guarantor's periodic statements.
- Does the guarantor have knowledge of good or bad loan repayment? Irregular loan repayments result in the setting up of individual loan loss provisions for risks of which it is necessary to be aware. Therefore, late payments must be reported and it is the lender that will record them. For guarantee companies that already have experience and for very small guarantees, these reports can be limited to events that actuate a loan loss allowance in the lender's accounting. For guarantees above this threshold and portfolio guarantees, monthly or quarterly reports should be envisaged.

Apart from these reports, it is in the interest of "start-up" guarantee systems and systems supplying high cover rates to carry out moderate checks with borrowers to verify that:

- it is not "ghost" credits that are guaranteed (the company being inexistent, the actual borrower being a relative or a friend of an employee of the credit institution);
- the loan was used for the intended purpose (for example, purchase of equipment) and not for financing, for example, a private celebration;
- lenders exercise professional monitoring of guaranteed loans and for credits in arrears loan loss allowances are established.

2.9.2 Restructuring/rescuing

In case of repayments in arrears by the borrower that contracted a guaranteed credit, the lender sometimes has the tendency to liquidate the collateral (including the external guarantee) and close the file once solvency is in doubt or in case of a minor payment incident. Such cases occur, for example, when the credit institution has changed its strategy and wants to reduce the share of SMMEs in its portfolio. On the other hand, several guarantee schemes advocate for a possible rescue attempt and accompanied by a reorganization of the loan.

Possible measures are:

- rescheduling of the delay to the end of the loan repayment;
- or a postponement of loan maturity.

The measure must be feasible: the businessperson will have to demonstrate the ability to face and honour the relaxation granted. If restructuring measures are possible, they should therefore be taken before irreparable damage is done. The guarantor must formally accept that the amount of guarantee contained in the delay extended into the future, is actually within his/her responsibility.

2.9.3 Default/claim

It is recommended to define very precisely, in the terms of the guarantee or the framework agreement, the event that triggers the guarantor's obligation to compensate the lender such as:

- the opening of bankruptcy proceedings against the borrower ;
- late payment/arrears over 90 days⁹³.

We know many countries where such a "leniency" is not the rule ... Before defining the precise conditions of the default, it would thus be appropriate to examine the provisions of the prudential regulations⁹⁴ and the usual banking practices of the country.

2.9.4 Procedures related to defaults and unpaid credits

It is the lender's responsibility to declare default since he is the one following the situation very closely. It is obvious that the guarantor must be immediately informed of the decision on the credit default. It consists of an individual report, which restates the reason for the sanction, the balance of accounts (with the breakdown of the outstanding debit balance into capital, interests and unpaid fees) and – as may be the case – a report of the visit to the debtor. He equally declares legal action measures that the credit institution will take and the estimated probable value of recoveries.

93 90 days arrears is the definition of default given in the Basel II Accord

94 Certain regulations recognize reductions in prudential capital required for well collateralized/secured credits ("the mitigation effect"). However, the definition of a good security may depend on, in the case of external guarantees, the period that the credit institution has to wait until the compensation by the guarantor

The information triggers measures on the part of the guarantor:

- the reopening of the file helps to validate the existence of the guarantee and its terms and conditions
 - if it falls due, a letter or visit to the banker helps to verify if proper implementation of the guarantee has been carried out: the loan has been well disbursed for the expenditure outlined in the investment plan (in broad lines); guarantor's commitment conditions have been followed (for example in the guarantees delegated to the banker)
 - the outstanding amount in distress is recorded in a special category of the off-balance sheet accounts
 - payment is made to the lender within the deadlines set by the framework agreement. As long as the money is not in the lender's account, interest posted to the debtor will also be charged to the guarantor. In accounting practice the existing individual loan loss provisions are debited and returned to the profit & loss account. The latter is then debited by the full loss amount required by the lender.
- If the guarantee is "joint and several", it covers the full extent of the guarantor's financial responsibility at that time and recovery actions for the guarantor's account must be initiated in a timely manner.
 - If the guarantee is "loss sharing", the payment is provisional and the guarantor will follow (and most often approve if the partnership is good) the recovery actions undertaken by the lender: appropriation of goods pledged by the debtor or request for legal authorization of sale.

The recovery process takes place. Say, at best ... In the "loss sharing" system, the lender defends his own interests and those of the guarantor. Recoveries should be properly credited to the account. Depending of a successful / unsuccessful recovery procedure, the provisional amount paid by the guarantor may be revised. If the interest is still accruing to the debtor's charge, it is no longer the guarantor's responsibility, as he has paid a provisional amount.

Then comes the time when the terminal loss can be established. The balance between the provisional payments and the actual loss is established. This results in a payment or a subsidiary refund, which closes the file. Undoubtedly, it is good to provide for the difference between the provisionally paid amount and the actual final loss amount to be coupled with an interest payment to the tune of ordinary financial investments in the market: this mechanism obviates the risk that at the time the provisional payment is being made, the interests of parties diverge: the banker aims at maximizing the sum that he receives and the guarantor at minimizing the sum that he pays.

At the time of terminal loss, the residual off-balance sheet account which records the final loss is preserved. On the one hand, the debtor is not discharged by the guarantor's payment and if he came back to better fortunes, the debt could be submitted to him once more. There is not too much illusion to have, but the possibility exists and the guarantor's intervention does not bring about debt forgiveness for the obligor.

In addition, if this debtor were to take part again in a guarantee application, for example through a new company, he could be identified.

If the credit institution has seriously and voluntarily failed to meet its obligations, the guarantee scheme would be discharged of its compensation obligation. This clause, which is found in all – or almost all – guarantee conditions/contracts, is prone to abuse. It has contributed to a decline in the reputation of some guarantee schemes. **It is advised here against exploiting minor breaches of the guarantee contract by the lender to refuse compensation.** Only the breach of contract which contributed significantly to the default, deserves being denied compensation.

2.10 Performance indicators: sustainability, additionality

The principal performance indicator of a private enterprise, in a market economy, is its profitability. But, in relation to the profitability indicator, most guarantee schemes are low-powered⁹⁵ for structural reasons:

Profitability ... sustainability ...

In principle, economic operators are remunerated for the utility of their product or service offered through an adequate price: the more the product/service offered is scarce and in demand, the higher can the profit margin be. Economists say that the useful effects which a business brings to the economy are “internalized” by the business.

Unlike most other businesses, guarantee companies and schemes face structural difficulties in “internalizing” the full useful effect that they bring to the economy:

- a) Guarantee fees that cover all expenses of the guarantee company may have such a high level that guarantee schemes risk a deterioration of the quality of their portfolios by an “adverse selection effect”⁹⁶: The higher the guarantee fee, the more likely prudent clients will withdraw⁹⁷, with the result that only bold and risky customers remain. This adverse selection effect has the tendency to increase losses as fees are increased. The level of expenses therefore increases with the price (fee) level!
This is a special case of external effects difficult to internalize.
- b) Additional reason: normally, it is the beneficiaries of guarantees (and not credit institutions) that ultimately bear the guarantee fees. Consequently, an increase in guarantee fees increases the financial burden of recipient enterprises and their likelihood of failure.

So if profitability is not a good performance indicator of guarantee schemes, it is proper to look for alternative criteria. We propose the sustainability concept, under the condition of producing sufficient additionality.

95 See for example Flaming (2007), p. 8 s.

96 effet anti-sélection” in French

97 This is a special case where the price (in our case, the guarantee fee) does not succeed in balancing supply and demand. See for example Stiglitz & Weiss (1991), p. 393 s.

First of all, what is the meaning of sustainability of a guarantee scheme?

A guarantee scheme can survive in the long term only if it limits the credit defaults that it has to indemnify. The principal condition for sustainability is a default rate that does not exceed a certain level. The most used measure is the portfolio at risk (PAR). A PAR (90 days) above 5 % for a long period is not sustainable⁹⁸.

Then, what is the meaning of additionality?

At the micro-economic – individual – level it is “making bankable” projects that would otherwise be rejected by the financial system not for reasons of viability but for lack of collateral or due to information asymmetry. It is also the integration of new or existing businesses into the formal economy. It is the capacity given to a motivated and competent individual to take his/her place in the society. It is as well the opportunity given to SMMEs to establish their creditworthiness and to become more familiar with banks’ practices.

At the macro-economic – global - level, it is the positive contribution to the creation of value added, employment, new wealth on which tax can be levied, exports. A consequence of the additionality criteria is that guarantee schemes’ destination is not cherry-picking, the selection of only excellent projects. Cherry-picking would allow a low default rate, but at the expense of lack of significance. Default rate alone therefore is not a good performance indicator of guarantee schemes. Rather, exceeding an acceptable default rate is a negative indicator showing that either the researched additionality has been set at a too ambitious level, or that too many non-viable clients have benefited from a guarantee, due to lack of professional analysis.

Finally, performance is not entirely reflected by the level of leverage between the outstanding guarantee portfolio and the equity. Surely, a multiplier effect is necessary, but long-standing service and the experience of the guarantee company as well as the representation in its portfolio of sectors most neglected by the community of lenders (for example, agriculture or start-ups or innovators ...) count as well.

98 cf. World Bank (2010): ‘... all countries in the benchmark group have kept net loss ratios (payment of claims/outstanding guarantees) below the 3-4 percent threshold, even when targeting risky types of borrowers’ (p. 32). The “benchmark group” in the World Bank study consists of guarantee schemes “that are reasonably well-established, including Canada’s SLFP, Chile’s FOGAPE, Colombia’s Fondo Nacional de Garantías, France’s OSEO, Hungary’s Garantiqa, India’s CGTMSE, Korea’s KODIT, the Netherland’s BMKB, Romania’s National Credit Guarantee Fund for SMEs, Taiwan’s SMEG, and the US SBA” (p. 9).

2.11 Towards a subsidiary and strictly limited government support that avoids distortions of competition

2.11.1 Generalities and conditions for support

Several authors doubt that a guarantee company can be sustainable without public sector or donor support. According to Ian Davies, for example, “almost all SME-oriented guarantee funds and schemes are not sustainable unless they obtain capital funds and continued subsidies ... In some countries and markets, SME-oriented guarantee schemes operated by private sector based guarantee companies still require ongoing government policy funding and cross-subsidization by more profitable non-SME commercial guarantee operations (construction, property and trade bonds etc)⁹⁹.”

For other authors, it is as a result of the waiver by most of its financiers to receive dividends and interest on market level that a guarantee fund remains sustainable¹⁰⁰.

In practice, few guarantee mechanisms operate without government or donor support. There are exceptions¹⁰¹: companies operating solely on the basis of their own solvency, given their integration into a solid and very close banking group. In addition, some financial companies offer guarantees and commercial bonds to SMMs or/and microfinance institutions in their range of products allowing for **synergies between these products**. As an example, there are guarantee companies in China offering a range of guarantees, including profitable commercial bonds and less profitable credit guarantees to SMEs. In Mali, the Banque Malienne de Solidarité has been providing Microfinance Institutions with credit guarantees, among others.

In a broader sense, we can mention synthetic securitizations that function like substitute collateral. Synthetic securitizations allow banks to transfer risk from parts of their loan portfolios to third parties, for example to ad hoc special purpose vehicles which issue securities on the capital market. Yet securitizations require a minimum size of portfolios from 10 – 20 million Euros, if not more.

Is it therefore inevitable to enter a logic of continuous subsidization of guarantee schemes by the government or donors? Our answer to this dilemma consists, in short, of a differentiated and conditional approach:

1. Examine if there is an opportunity to offer loan guarantees to SMMs and microfinance institutions within the framework of financial companies that offer a range of different financial products allowing risk complementarities **between them** (cf. the example of China mentioned above).
2. Otherwise, the creation of guarantee companies or funds could be encouraged by local municipalities or States or donors **on condition that the private sector concerned** (financial institutions, entrepreneurs, business associations, Chambers of Trade, ...) **provides about the same volume of equity** to the guarantee schemes by real in-payments (and not just pledges or commitments for contributions).
3. In any case, before giving the green light for support, some basic conditions must be verified by a neutral and competent third party, for example, a recognized audit firm: a sufficient volume of demand, the possibility to reach a sufficient diversification of the portfolio, a broad consensus on behalf of different stakeholders ... If positive basic conditions are not met, external support may subsequently turn out to be without object.

99 DAVIES Ian (2007), p. 33

100 ACCION (2005), p. 8

101 French Mutual Guarantee Companies of the SOCAMA Group – Banque Populaire – for example.

4. Anyway, in all cases and countries **distortions of competition should be avoided**. To avoid them, the group of EU experts BEST¹⁰² has selected the following criteria:

- Preferably, guarantees are granted to small-sized businesses;
- Guarantees for medium-sized enterprise are granted if the latter are competing with large companies.
- Access to guarantees must be open and non-discriminatory.
- In case of a loss event, the beneficiary of the guarantee (the entrepreneur) must remain debtor and the credit institution has to bear a share of the loss of 20 % at least¹⁰³.

The first two criteria basically mean that the guarantees compensate for disadvantages experienced by the SMEs compared to large companies.

Guarantees by the Government or donors in favour of microfinance institutions – and decentralized financial systems – should equally avoid distortions of competition. Of course it does not make any difference whether the guarantees are for refinancing loans contracted from banks or for debentures/ bonds issued on the capital market. The MFIs – even non-profit – compete with each other. This competition is generally useful and should not be distorted.

2.11.2 Instruments of support to guarantee companies

If the criteria are met, what are the instruments used to support guarantee companies or funds? In practice, the following instruments have proved useful, under the conditions specified hereunder:

- contributions to the equity capital of guarantee companies
 - loss sharing through counter-guarantees or the equivalent,
 - subsidization of the guarantee fees,
 - tax relief.
- a) Creation of guarantee companies or funds could be encouraged by the **supply of equity capital** by the Government, municipalities or donors provided the private sector shows interest and contributes about the same amount of equity capital to the guarantee scheme. It is important that they be actual payments and not just promises or commitments.

The volume of equity should be sufficient to generate a financial investment income that contributes substantially to the coverage of the operating costs.

b) Loss sharing by:

- guarantee insurance (for example, the Japan Small and Medium Enterprise Corporation, JASME)
- securitization of loans granted
- **counter-guarantees** (Germany, Korea, Spain, European Investment Fund, GARI Fund in West Africa).

102 BEST (2005)

103 BEST (2005) p. 14

The insurance by JASME of guarantees granted by Japanese guarantee corporations is similar to counter-guarantees. The Small Business Credit Insurance Law was established in 1950 for the protection of the main guarantee issuers, a system that combined credit guarantee with credit insurance.

Securitization is a modern instrument which bundles risk portfolios by transforming the risks into securities, and sells them to big investors in financial markets. The efficiency threshold is very high with the result that this instrument is not interesting for schemes that do not have a very high volume of guarantees in portfolio or whose threshold of losses is not minimal.

To the question whether counter-guarantees and guarantee insurance are not a superfluous level or an “over-sophistication”, we reply that the rationality of counter-guarantees goes beyond the simple support to the profitability of guarantee companies. In order to understand this rationale better, it is proper to cast a glance at the nearby insurance sector: Reassurance allows insurance companies to diversify their risks.

The terms of counter-guarantees have been stated in numerous ways:

- Counter-guarantees have been practiced like a general umbrella deployed over the solvency of a guarantee entity. This reassures lenders: if the principal guarantor goes bankrupt, the financial responsibility will be forwarded to another party (the counter-guarantor). But to set the counter-guarantee in motion, the principal guarantor must be insolvent and therefore the tool disappears, a condition that bears in itself the vice of this principle. **Counter-guarantee is therefore very widely practiced as a case by case cover**, with an intervention each time that the main guarantor suffers a loss.
- The **counter-guarantee actors** can be various, usually a public authority that intervenes directly (State, Region) or through a specialized market entity (public agency). But we can also find private companies (in elaborate guarantee schemes which have a local and a national level, the latter counter-guaranteeing the former) or a supra-national financial institution, following the example of the European Investment Fund¹⁰⁴.
- The counter-guarantee may be provided with a **cap**: a maximum beyond which it no longer applies or with a stop-loss. For example, to limit its risk, the European Investment Fund grants counter-guarantees at a certain percentage (mostly 50 %), but in addition it puts a ceiling on its risks to partners through caps. Caps are determined primarily on the basis of expected losses/claims.
- **Automatic** counter-guarantee: it does not require further analysis of guarantee applications. It suffices that the counter-guarantor has confidence in the quality of the guarantor’s decisions, on the basis of regular monitoring. Simultaneously, the counter-guarantor can stipulate that it sends a delegate to the Board in charge of decisions to grant guarantees (the case of Germany) or at least an observer. Or the counter-guarantor specifies the risk policy that the guarantor will have to comply with in order to receive the counter-guarantee.
- The rate of risk sharing with the main guarantor can be fixed (for example, always 50 % of each loss) or variable (for example 50 % sharing for start-up companies and 25 % for existing businesses, or ... or ..., according to the economic policy priorities of the counter-guarantor).

104 www.eif.org. The European Investment Fund, a subsidiary of the European Investment Bank, works in a delegated mission on a European Union budget to grant free counter-guarantees to guarantee operators. The latter must undertake additionality commitments to receive support that is contractual: for a defined portfolio, for a limited period of time and with a stop-loss on intervention of the FEI, if it is free. For further details see http://www.eif.org/what_we_do/guarantees/cip_portfolio_guarantees/loan_guarantees/index.htm

- Finally, the cost of the counter-guarantee may be subject to various modalities, especially:
 - provided free (similar to a subsidy)
 - a free scheme with punitive rate if the main guarantor exceeds a defined threshold of loss
 - a limited fee. (i.e. a fee that in % of the guarantee fee of the main guarantor relates to a cover that in % is higher than the protection provided by the main guarantor)

A conditional counter-guarantee

Undoubtedly, Spain has one of the best regulated guarantee schemes amongst all.

Among the supports to the guarantee scheme features the public counter-guarantee issued by a specialized agency, Compañía Española de Reafianzamiento (CERSA).

Two features are of interest to us:

First, the counter-guarantee is modulated according to public priorities (a guarantee issued for a credit aimed at innovation or the creation of a new enterprise receives a counter-guarantee of 70 %. On the other hand, a guarantee on credit for working capital is not counter-guaranteed).

Furthermore, counter-guarantee is free. But if the guarantor's performances are insufficient because he exceeds a level of loss events/claims considered acceptable, the counter-guarantor has powers to adjust and his counter-guarantee becomes fee-paying.

What are the economic effects of counter-guarantees?

- They reduce the potential risk of the guarantor; they therefore improve the profitability of the main guarantor.
- They develop the guarantor's business with the same level of equity capital: a 50 % counter-guarantee of the portfolio allows doubling the latter without additional exposure to risk.

c) In the case of young guarantee schemes, a **fee subsidy/guarantee premium** can equally be justified on a temporary basis. This is a second technique that helps to increase the financial sustainability and raise the chances of growth of guarantee companies, especially when they are not yet familiar with market conditions through sufficient experience.

The guarantor evaluates the probability of failure at a level that allows him greater security. He does not penalize the borrower through a fee too heavy to bear. He therefore brings down the fee to an affordable threshold and the support authority pays the difference.

d) Tax relief

Almost half of the guarantee schemes in the whole world are exonerated from paying tax on their profits¹⁰⁵. On the other hand, these schemes do not have the right to pay dividends.

The tax relief creates an additional advantage: it removes the temptation on Finance Ministries to reduce the loan loss provisions of guarantee companies and funds, in order to increase taxable income. For loan loss provisions are a key tool for risk management.

However that may be, before giving the green light for support, a sufficient volume of demand for the services of the scheme must be forecast by a neutral and experienced third party (for example, a recognized audit firm). If such a volume of demand seems unlikely, external support may subsequently prove to be a waste of resources.

2.11.3 Legal standards for a rigorous approach

The grant of guarantees or counter-guarantees by the State, by a subordinate public authority or a municipality gives rise to potential expenditures to indemnify the unpaid lender. At the time of default, compensation of the lender is a contractual obligation (of course under the conditions of the guarantee/counter-guarantee contract). Consequently, it is at the time of granting the (counter-) guarantee by the state or a municipality – and not at the time of compensation – that an **authorization for granting guarantees must exist in the budget** of the public (counter-) guarantor, otherwise there is danger of erosion of the prerogative of the authority (normally the parliament) that decides on public spending.

The existence of budget appropriations for payment of compensations under guarantees extended does not contradict the need for guarantee authorizations at the time of grant. The budget line for compensation on account of guarantees has a different function, namely of compelling the executive branch, at the time of submitting the draft budget to the legislature, to make manifest the risks inherent in guarantees extended in the past. For if budgetary appropriations prove to be insufficient in a budget year to meet the compensation obligations on account of guarantees extended in past years, government must either ask for authorization to transfer resources from other budget lines, or to increase the budget line for compensations.

As stated above, budgets should regulate and limit the grant of guarantees. This regulation and limitation can be carried out by means of:

- ceilings on authorizations to grant guarantees, see lit a) below, or
- separate budget funds for guarantees, cf. lit b) below.

In both cases, the budget law voted by the Parliament must include conditions that have to be complied with by the granting executive authority (e.g. Ministry of Finance), see lit c) below.

a) Ceilings on the provision of guarantees

Budget authorizations for guarantee extensions should be limited to operations without considerable probability to incur loss. In case of higher guarantee risks (with a high probability of compensation payments in the future) the correct budgetary tool is spending commitment appropriations¹⁰⁶, rather than simple guarantee authorizations. For it is good practice that the State does not have the right to commit itself legally to future spending except by commitment appropriations provided for in the budget. Otherwise, it would be easy to erode the prerogative of the legislature to decide on public spending.

To prevent the executive branch from circumventing these requirements of orderly budgeting, some Parliaments make the provision of guarantees subject to the prior approval of the Budget Committee. The budget law can even provide that a government guarantee has legal force only subject to the prior approval of the Budget Committee.

It happened that a public authority granted guarantees for risky credits, namely credits that had ex ante abnormal probability of default, for example to businesses already in difficulty and without restructuring plan comprising shareholders' commitment to recapitalize the business. These cases have been criticized on grounds of representing circumventions of the requirement in such cases to provide for budgetary spending commitment appropriations, as simple guarantee authorizations do not suffice in cases of likely future expenditure.

b) Separate guarantee funds

A very cautious legislature with regard to guarantee risk can prohibit the granting of guarantees by the executive branch with the exception of those granted on the basis of separate guarantee funds, with a certain amount of funds actually released.

c) Conditions that have to be complied with by the granting executive authority It is proper for the legislature to subject the granting of guarantees to companies to certain conditions:

- The granting of guarantees should be targeted to recipients worthy of support, according to policy priorities. One of the virtuous goals could be to limit distortions of competition faced by SMEs in their access to credit.
- Moreover, the grant of guarantees in favour of businesses, even microenterprises, should be limited to cases of lack of collateral. Support for businesses of questionable profitability should be excluded by compulsory budget rules, the non-compliance with which has negative consequences for those responsible.
- The provision of guarantees for high-risk projects should equally be excluded. Budget frameworks for guaranties should be limited to operations that only have a fairly low probability to become non-performing¹⁰⁷.

Moreover, it is appropriate to limit guarantees by mixed economy companies that benefit from a participating interest by or a guarantee of a local authority¹⁰⁸.

106 French: crédits d'engagement ; German: Verpflichtungsermächtigung

107 otherwise, the correct budgetary tool is commitment appropriations, cf. above

108 see for example MATTRET (1997) p. 99 s.

2.11.4 Effective external control mechanisms

If the state supports guarantee companies, or if the State itself manages a programme of guarantees, the Court of Auditors must have full powers to carry out all controls that it considers appropriate, and in an independent manner. In those countries where the Court of Auditors is not independent of the Executive power or where the Court of Auditors does not have the right to report directly to the Parliament, it is advisable to provide for a different, independent control agency.

2.11.5 A coherent approach of public action

Mandatory and compelling legal provisions are to be provided at all levels of public authority, including municipalities, special purpose funds and public banks. Otherwise, bad surprises caused by guarantees granted in an irresponsible manner will appear without warning. In fact, granting guarantees while under-estimating their risk has, in the past, drained budgetary resources in several countries.

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3. Setting-up a sustainable guarantee company: Methodology

Setting-up a guarantee scheme is not an improvisation exercise. It is equally not an exercise of “copying and pasting an existing system” as many various models coexist and function correctly.

The parameters governing the creation are all the same, but the options form a tree structure. The choice will be guided and informed. It is important that:

- the path of successive decisions is marked out by the objectives and validated options according to the prevailing economic conditions,
- in the end, the profile of the institution is homogeneous and coherent,
- all operational aspects are addressed including seemingly non-priority subjects like, for example, the management of defaults.

We propose a methodology in four steps:

1. The first module is a purely documentary and exploratory phase conducted by the developers. Relevant documentation is collected on legal aspects. Moreover, a market research reveals the segments where the utility of a guarantee facility could be optimized,
2. The second module consists of a home work. In the light of the conclusions of the field research, it addresses the fundamental options and the guiding principles of the architecture. It is an outline that allows an initial discussion among partners, which will ensure the subsequent consistency of the general architecture of the project,
3. Thirdly, the viability of the project is tested within an expert working group of stakeholders, with focus on the financial parameters and the peripheral elements of support. Their remarks and suggestions should clarify the draft project of the developers. Their commitment to step in is expected as the feasibility and the additionality of the facility have now been discussed in depth.
4. The fourth stage is essential since it leads to the actual foundation of the company. By publishing the business plan and drafting the articles of association, this phase leads to the final agreement of partners, and approval of the prudential supervisor. The powers of the decision-making bodies are defined and key employees are hired. The setting-up process ends with the definition and approval of products, written procedures and contracts. Tools for processing information are designed and implemented. The organization chart of the company is developed.

MODULE	GOAL	ACTIONS
1.	EXPLORING THE ENVIRONMENT	<p>LEGAL CONTEXT</p> <ul style="list-style-type: none"> ■ Legal framework applicable to financial Institutions ■ Company law ■ Law relating to credit securities and personal guarantees ■ Tax laws <p>MARKET RESEARCH</p> <ul style="list-style-type: none"> ■ Entrepreneurial tissue with a focus on SMMEs ■ Credit institutions serving SMEs ■ Microfinance institutions
2.	FIRST PROJECT: BASIC CHOICE	<ul style="list-style-type: none"> ■ Market segments ■ Targetted “Core Business” transactions ■ Possible legal status of the guarantee facility ■ Prudential supervision framework ■ Potential partners and shareholders ■ A draft of the operational structure
3.	FOCUS ON SOLVENCY	<ul style="list-style-type: none"> ■ Equity capital ■ Guarantee commitments portfolio ■ What kind of risks to cover? ■ Guarantee fees and other income sources ■ Modes of risk sharing ■ Possible public support
4.	FOUNDATION OF THE ENTITY	<ul style="list-style-type: none"> ■ Business plan ■ Agreement of the prudential supervisor ■ Call for funds to shareholders ■ Drafting of statutes ■ Defining organs of the company ■ Hiring key people
5.	OPERATIONAL ISSUES AND ACTION PLAN	<ul style="list-style-type: none"> ■ Guidelines and policies ■ Documentation of a guarantee application ■ Risk assessment and decision making ■ Framework contract with financial partners ■ Guarantee contract with borrowers ■ Products ■ Accounting and information system ■ Organisation of internal control <p>CONCLUSIONS</p>

3.1 Module 1: Exploring the environment

General purpose of the module:

- Legal environment varies from country to country. Specific legal aspects must be studied in detail.
- A well-prepared market research will help proceeding on solid ground. Observers and potential advisors are identified in the circles of micro-entrepreneurs, small businessmen in the formal sector, lenders (namely banks, leasing companies and microfinance actors), lawyers, institutions (Central Bank, SMMEs Agency), holders of political responsibilities. The best approach is to meet those stakeholders, to investigate their perceptions by qualitative in-depth interviews. Their views are collected, compared and analyzed in the light of available statistical data and studies. In doing so, not only the utility of a guarantee facility becomes clearer but also a supportive network of professionals is sketched. The first contact is a key for further cooperation and trust.

A detailed written report will pave the way for phase 2.

3.1.1 The demand side: financial markets and small businesses

The target of the guarantee mechanism is primarily based on a broad and in-depth knowledge of the SMMEs sector and a specific analysis of market failures as they are felt and experienced by small entrepreneurs. Market research consists of gathering general information (statistical data and even approximations are all welcome) and consulting with representatives of business organizations (expert opinion). Country reports by international organizations, views of national and regional observers are useful as well.

Information received from various stakeholders is crossed. Divergence and consensus points carefully noted.

The main descriptive features of the market

The following macro-economic issues must be addressed:

- The general economic climate? Stability/ volatility of the economic environment, making its middle-term evolution foreseeable?
- SMME's in general: official definition, availability and reliability of updated statistical material, the profile (number of businesses, employment, contribution to GNP ...)?
- Second layer of analysis: registered and informal enterprises, sectors, exporters?, start-ups, takeover and family successions, regional distribution (growth poles, poorer areas), agriculture and farming sector with its trade channels
- Public support policies: regional / sectoral priorities? Assistance to start-ups, to exporters, to innovators? Any SMMEs Promotion Agency? Effectiveness? Any subsidization policy?
- Business associations: which ones (e.g. Chambers of Commerce, Craft, Industry)? Their representativeness? Their financial and political power? Their role in the field of access to credit (training, monitoring loans applications)?

SMMEs and their access to credit

Likewise, the following topics are carefully explored:

- Financial facts: average size of formal SMMEs (total assets), average capitalization (own funds / total assets)?
- Funding/ financing: Own resources? External financing (Micro-finance institutions, informal lenders, banks actually granting business credits or personal loans)?
- Credits: main needs (working capital, investments?) (detailed overview according to sectors and to business size)
- Accounting requirements for registered companies? Are financial statements timely up-dated and reliable? Is there any central database that can be consulted?
- Gaps and failures (peers and experts opinions regarding credit supply): lack of open dialogue, high loan collateral requirements, unavailability of long term credit, exaggerated interest rates, opacity of products, reputation and credit history not considered, cumbersome credit files and administrative burdens, too long delays, etc.
- Would a guarantee mechanism bridge market gaps? What is expected?

3.1.2 The supply side: financial markets and banks

Market research consists of collecting statistical data, consulting with the National Banking Association, reading banks' annual reports and conducting interviews with high executives and credit managers. This facet aims at defining who could partner with a guarantee facility and how that tool would be accepted and used.

The main descriptive features of the financial market

- Prevailing financial conditions: interest rates currently and actually charged on personal loans – on overdrafts – on investment loan with respective terms of 3 and 5 years ...; additional fees and commissions on top of the interest? inflation rate, interest paid to saving deposits?
- Banking institutions operative in the small business market: which ones? The size of their SME portfolios? Their regional distribution network? Special products for small businesses? Market segments currently targeted / rejected? Attitude vis-à-vis non-registered enterprises? Farming and agriculture?
- Credit decisions: Their general terms and conditions (rights and duties of the lender and borrower)? Exigencies regarding collateral securities (types of collateral accepted, their borrowing power)? What hierarchical levels are the seats of decision-making for business loans applications? Assessment criteria? Discrimination between a viable and bankable project and a viable and non bankable project? Rate of rejection of business loan applications? What are the main reasons? Approximately the rate of loss on business credits granted by banks?
- Is there any Development Bank with the specific mission of promoting SMMEs? Is there (like in many countries) a lack of long-term capital supply?
- General opinion about a guarantee facility: What is expected? Would “downgraded” collateral securities be relevant for a guarantee scheme?

Deficiencies in the SMMEs market seen by financial institutions

Lenders can be reluctant to operate on the SMMEs market. Here are some reasons.

- Their credit policy rejects the informal sector and any entrepreneur without a bank account. The micro-enterprise niche has no priority in the bank's strategy. Lenders only speak to well established businesses with track records and secure collateral,
- Little competition exists between financial institutions and each one practices cherry-picking,
- Small loans are too expensive and few applications meet the acceptance criteria by the bank,
- Financial information provided by SMMEs is not reliable, causing information asymmetry,
- Entrepreneurs are not trained to understand financial issues, to make a business plan,
- SMMEs' own funds are not significant enough to back commercial debts and bank credits,
- Lenders reject most of the collateral securities proposed by small credit applicants as they are pledged on business assets,
- Bankers give a low borrowing power to a mortgage on commercial properties as forced sale markets are not very active. Legal procedures for seizure and resale of collateral are slow and cumbersome,
- Banks do not have products accessible to this category of customers,
- They are reluctant to extend medium/ long term loans (beyond 6 months? ... 12 months?),
- Lender's experience with SMMEs shows too high default and loss rates.

3.1.3 The supply side and microfinance institutions

Guarantee is equally a useful complement with micro-finance

Survey of the microfinance sector

- Active institutions: Which ones? Their shareholders (NGOs, donors, authorities, financial sector, organized civil society ...)? Their experience and effectiveness? Size? Do they dispose of sufficient available funding means? Are they looking for additional sources of funding?
- Activity: Market targets? Products? Financial conditions? Market performance (outstanding amount of loans, volume of loans granted annually)? Average size and maturity of a microloan?
- What is their financial performance (annual statements)? Average loss rate?
- General opinion about a guarantee facility: usefulness? Expectations (help to collect additional funding thanks to which they expect a better performance?, portfolio type guarantee ...?)

Market deficiencies seen by the microfinance sector

Accessing the SMMEs market via microfinance institutions requires special conditions as, most probably, the technique of direct guarantee is not feasible; other techniques must be put in place: portfolio guarantee or indirect guarantee covering the acquisition of funding means.

The enquiry shall bear upon:

- What is the potential unmet credit demand? Is the funding of microfinance institutions sufficient to achieve a critical threshold? Or are additional funding means necessary?
- How do microfinance institutions secure their loans? (for example, co-debtors' solidarity group). Is there any perspective for a guarantee coming on top of a pool of loans?

3.1.4 The national legal context and its possible application to a guarantee company

Legislation applicable to financial institutions and supervision

The first option is related to a situation in which the banking law follows international standards.

The following points can be checked so as to verify that the regulation in force is forming a suitable anchorage for the new guarantee instrument:

- Does the national regulation apply the latest “Basel principles” and what is the supervision authority?
- Do the legal requirements fit with a guarantee company?
 - Foundation of a financial institution?
 - Competence of the decision makers and structure of the decision bodies?
 - Equity capital, Risk Assets Ratio?
 - Accounting, reporting, disclosure of financial statements?
 - Credit policies, risk provisioning?
 - Management?
 - Risk coverage of the assets and risk mitigation systems?

Alternatively, a specific prudential legislation could apply if it is possible and suitable.

- Would this second best solution satisfy financial partners in terms of robustness and trust?
- Is it politically feasible (requiring a legislative initiative, discussion, vote)? How long would it take?
- What are the opinion of the Administration and the Central Bank in this respect?
- How should the regulation be designed? (creation, solvency, liquidity criteria, make-up of the management, control and sanctions)

As a last resort, the projected company will not be submitted to any regulatory frame ... the worst case, as concerns could be raised about its survivability and secure management.

The place of the guarantee in the national toolbox of credit collaterals

- What types of credit collaterals are recognized by law? Which ones are commonly used by lending institutions?
- Do they actually secure the creditor against credit risk? (Example: cadastre of real estate does not provide full security on title deeds – a legal register is lacking for mortgage notification and conservation ...) What value do financiers ascribe to a mortgage, a business asset ...?
- Is the personal guarantee qualified as a legal security? Can it be limited to a portion of the credit exposure or to a period shorter than the credit maturity? How is it enforced? How is personal guarantee expressed in a commercial contract? How can the guarantee granted by a professional company be discriminated against other personal guarantees offered by natural persons (a father for his son, the owner for his company ...)? Is it possible to subordinate the first to the second?

- How is that legal frame interpreted and applied by courts in case legal action is taken against the debtor? How long does it take, on average, to settle a bankruptcy?
- Is prosecuting a failing debtor over a security settled by the seizure of his property and its adjudication to creditors or through a legal forced sale procedure organized by the court?
- Which lawyers can best advise in that matter?

Legal provisions regarding legal company forms

Various options are open regarding the legal status of a guarantee instrument. It can be envisaged as:

- A government body endowed with an annual budget, managed within the Administration. The issue of a company form is not relevant.
- An autonomous public agency (type public development bank) under the public companies legal forms framework
- A private company founded by various partners (possibly including public shareholders). The legal form will be chosen in the range of various possible company statutes (cooperative, limited liability or joint stock).

A. The mutualist models go hand in hand with cooperative articles of association.

The variable capital allows a variable number of members as any beneficiary of the guarantee service must become a member of the cooperative. If necessary, the “One Man – One Vote” rule may be observed and permit members to be elected into management bodies so that guarantee decisions are made by peers. But...

- minimum equity capital is the key issue. Most of the time, this amount does not fit with the actual needs of a financial institution. The question of trust is again in the forefront.
- the financial liability of multiple small members cannot exceed the paid up amount.
- Moreover, it will be necessary to implement professional management principles (accounting, financial disclosures, auditing) in this shell.

B. Non mutual models can agree on “joint stock” / “limited liability company” statutes

Reviewing the same issues to make sure what kind of company form can properly host the guarantee activity.

C. Is a foundation possible?

In this configuration, fund providers lose ownership of their capital investment, but continue to assume the management rights. The foundation solution is possible, but it poses very delicate concerns.

Legal provisions regarding tax principles

- What is the corporate tax rate in force?
- How are provisions for credit risk (individual/general) being handled? Can risk allowances be deducted from the corporate tax base?
- Are guarantee fees and other operating income subject to indirect (value-added) tax?
- Do development agencies benefit of a preferential tax system? How to maximize the tax benefits?

3.2 Module 2: Basic options

General purpose of the module:

- In a second phase, the developers build on the information collected and they assess the validity and feasibility of a guarantee facility. It consists of evaluating its utility function by comparing the potential performance of the instrument with the current situation, its strengths, weaknesses, opportunities and threats.
- If the project looks relevant, the promoters will use their experience to outline the general design that complies with the local market and with the legal framework.
- Developers are making an “in-house” sketching without even addressing the funding and sustainability aspects. The option is to verify that the project bears an added value to SMEs, lenders and to the national economy. It would then find supporters. But further discussions with stakeholders can only start on a detailed and informed written report .
- To be more realistic, the chapter develops a purely illustrative case.

3.2.1 The potentialities offered by the market

Data collected in the first phase shed light on the feasibility of the project. The actual situation of the economy raises the following questions:

- Shall the facility generate micro- and macro-economic benefits (additionality)?
- Did lenders and borrowers show a readiness to accept an intermediation facility in the credit chain? Is there a kind of consensus about solutions to address market failures?
- What are the main market gaps? Are they forming sufficiently large market niches to effectively accommodate a financial institution?
- Towards what type of guarantee are we heading? Wholesale or retail? Turned to the banks or to micro-finance?

Characteristics of negative economic and financial situations

Market research paints a picture from which we can draw realistic conclusions. In poor macro-economic situations, doubts can be expressed on the effectiveness of a guarantee scheme.

The following indicators are alert signals ... or red lights:

- Business tissue with a high number of bankruptcies, little or no creation of new businesses,
- Negative growth rate of GNP,
- Very high rate of inflation triggering prohibitive interest rates,
- No confidence in the State
- Financiers refuse to co-operate with a professional guarantor under conditions acceptable to it; it is feared that they would behave as predators.
- Legal systems of real estate property and collateral registration are not reliable such that the legal securities regime is completely disorganized. In case of defaults, recoveries are highly problematic. Risk sharing between lender and guarantor makes no sense.

Precautions and exclusions of activities

A number of market situations require a prudent approach:

- Too small market segments (for example: guarantees solely for taxi drivers). From the outset, sectoral and geographical diversification is to be considered. In order to enclose the agricultural sector in the perimeter of activity, it might be preferable to open a specific window.
- Addressing only risky sectors (e.g.: start-up companies) instead of having a mix of risks in a balanced portfolio. The coverage of commercial and technical risks in addition to the protection against credit risks is desirable. Partnering with too few lenders: being in the hands of one bank jeopardizes the sustainability. Working with two or three lenders drives the guarantee into a strategy that would “copy and paste” their policies. Being friend with seven to ten financial institutions is the good practice, even if some of them are not regular customers.
- Serving only one type of credit transaction (for example, investment loan). A mix of short and medium term credits, aimed at financing working capital and investment is preferable. Adding technical and performance guarantees lowers the average probability of default. Similarly, certain sectors and certain transactions are to be excluded:

Non eligible activities are:

- Gambling,
- Illegal trade (drugs, weapons),
- Financial activities (loans, insurance),
- Undesirable activities like that damaging the environment ...

Non eligible transactions are:

- refinancing of existing credits,
- loans to “unrecoverable” businesses (restructuring credits are possible),
- speculative real estate transactions,
- speculative financial transactions,
- credits to business persons pursuing only a private goal (family house).

Potential market segments

In summary, the target market and priorities shall ensure a sufficient market size, portfolio diversification and acceptable level of risk while responding to the challenge of generating additionality in terms of access to credit for SMMEs, new market opportunities for lenders, more jobs and added-value creation in the economy.

The best situation occurs where lenders are currently “skimming” the market by selecting well-guaranteed good projects and give up all other proposals. In this frequent hypothesis, it is possible to “open a breach” for “good but poorly guaranteed” projects that are just below current banking standards.

How to make a good segmentation?

A/ In the formal economy:

- The project envisages a “retail” direct guarantee supplied to banks or leasing companies.
- The table below proposes an example of opportunities and priorities (to read column by column with shaded cells pointing out on activities where guarantees fit well or activities to prioritize).

SECTOR	LIFE CURVE	SIZE	TECHNOLOGY	PURPOSE OF CREDIT	SECURITIES OFFERED
Commerce	Scratch, inception	One-man business	Traditional know-how,	Comprehensive Start-up programme	No securities of the company
Services and liberal professions	Launch/no track record	Micro firm (1-9 Staff)	Existing, well-known technology	Replacement of machinery, renovation of fixed assets	Collateral by personal guarantees
Building industry	Existing > 2 years + slow growth rate	Small (10-49) low turnover	Known technology, new for the firm	Expansion additional equipment	Partial collateral on real assets < 50 %
Craft sector	Existing > 2 years / fast growth	Small, average turnover	Innovation, new technology	Expansion by conquest (new markets, products...)	Partial collateral on real assets > 70 %
Industry	Succession and take over	Average (10-250), average turnover	Research process	Working capital needs	Complete collateral
Agriculture	Crisis and distress	Average + high turnover		Research and innovation	

Encouraging perspectives are detected in the market when:

- Many SMMEs having a bank account are not yet credit reliable because of insufficient / unacceptable collateral securities.
- The demand side is open: many businesses are eager to get credits as the economic environment is promising.
- The economy counts promising sectors that would generate a development wave: the tourism sector and its complementary services, construction and building renovation, crafts industry, agricultural processing activities ...
- A number of SMMEs that are emerging in terms of creditworthiness wish to invest through leasing (taxis, light mechanical work, small subcontractors ...). The guarantee will be used either to give an additional protection to the leasing company, or to guarantee the financing of the up-front payment.
- Agricultural cooperatives are in place or in being founded in order to purchase commodities and sell their members' production. They can have a stirring effect for small agricultural producers. Storage or processing tools can be improved upon.
- Interesting conclusions can be drawn on the place of potential users on the life curve of businesses, in particular beginners, young graduates who want to be self-employed, enterprises in the growing segment of the curve.

B/ In the informal economy:

In principle, guarantee does not apply directly to businesses that are not officially registered.

However, indirect action is possible through microcredit lenders.

- Many of them have gained sufficient experience. They wish to develop their business by collecting additional funding with the support of a strong guarantor.
- A guarantee portfolio can be negotiated with a 50/50% risk sharing bearing on e.g. pools of credits to existing customers who have timely repaid previous loans. As a consequence, micro-lenders will be able to consider transactions of greater nominal value or of longer maturity. The management of loans portfolios and credit risks will be improved without administrative burden. Their cash management and prudential ratios management will be eased as well.

THEORETICAL EXAMPLE

We develop here, in pedagogical and simplified terms, a theoretical example which, through chapters will illustrate a process of setting-up a guarantee company.

The case is not inspired from a case lived. Its conclusions are limited in order not to make the case too cumbersome.

The example should teach how the approach goes from the market towards the project, from "rustic" observations to an elaborate construction and from a group of developers to all stakeholders. Options successively taken must be fully consistent with the legal framework. They will always be validated by plausible assumptions of financial sustainability and trust on behalf of partners. The creation phase does not end so long as a comprehensive review has not been made and all operational aspects addressed.

The underlying economy is assumed to be small, stable, and in a promising take-off phase.

Observations drawn from the market research from the supply side:

- Banks address business of “good to very good quality”; they cease abruptly to be partners under a quality threshold defined by acceptability parameters that are quite strict ... This strong selectivity explains the limited business volume with SMMEs and the limited rate of loss (around 1%). For some banks, the small business sector could be an opportunity of clientele diversification by cross selling. Some credit managers stated that slightly lowering the level of exigencies would create business opportunities with new clients without creating an unbearable loss rate if an external strong guarantor would be involved.
- Both by legal obligation and out of prudence, banks look for strong collateral securities. This severely limits the growth of credit portfolios.
- Banks express limited confidence in the financial statements of SMMEs. But local branch managers know the value of good clients. Their network is mainly developed in urban areas rather than in rural areas. A green light given by their Headquarters and the assistance of a guarantee scheme could be the signals of a take-off.
- Banks have limited funding available for credits over 3 years.
- The segment of credits comprised between 20,000 and 70,000 is poorly served.
- There are few “small business” financial products in the range of banking products, except credit cards and export credit accessible to a minority of customers.
- The differential between the average lending rate for business credits of 1 year and the average deposit rate for savings deposit is 6 to 8%. The fee charged for the guarantee service would negatively impact the spread, but undoubtedly leave a margin.
- To obtain a positive activation effect, the maximum rate of a “loss sharing” guarantee should reach a fairly high proportion of the credit. For leasing operations, a lower rate could suffice.
- Financiers would be sensitive to a mechanism that indemnifies them as soon as the default occurs. They want to avoid legal court procedures which are described as slow and expensive.
- The financial sector’s collaboration proposal is rather cold although there is a temptation to address the small business market. The Agriculture sector arouses much less interest ... It seems that five banks and two leasing companies could partner with the guarantee society if the financial conditions are convenient for them.
- There is a development bank that offers promotional rates, but its resources are limited with regard to the market. Terms of co-operation should be found.
- The National Banking Association is not opposed to the idea of creating a guarantee scheme, but requests that it be robust and well managed.
- Leasing companies are mainly active in the “private cars” segment and little in professional investments. A proposal has been made: either a higher initial down payment is made thanks to a credit covered by the guarantee. Or the guarantor undertakes to pay the remaining residual amount at the end of the leasing period. The second solution looks more risky ...

Observations drawn from the “microfinance” side of the market research:

- One institution is fairly new. Two others were created five year years ago. They are developing properly, especially in the informal economy. Their loss rates are acceptable (2.8 % to 3.5 % according to their statements). They have an adequate network and have the confidence of their customers according to a recent study. The government is much in favor of their action.
- Their limited resources compel them to limit their activity to fast revolving (1 to 6 months) and small amounts (max. 1,000 Euros).
- Interest rates are higher than market rates (14 % per annum).
- One of them has almost exhausted its funding resources. It should increase its funding by borrowing 10 million. The General Manager believes that a guarantee supplied to a local lender would facilitate the transaction and help to reduce its interest rate.
- Both institutions could moreover grant more substantial amounts of loans to the informal economy and for longer terms to their “loyal” customers.

Observations drawn from the “entrepreneurs” side of the market research:

- There are several business associations, but only one is representative and relevant.
- Chambers of commerce are quite involved in business life but few small entrepreneurs are their members, a situation that they regret and would like to change.
- A State owned Small Business Agency is very positive about the idea of launching a guarantee facility. However, its budget is limited.
- Business people are sensitive to the rates of their loans, but could even accept a slight increase if they were to receive the necessary amount, the appropriate duration and the right product.
- The formal entrepreneurship fabric is under-represented. A strong presence of the informal economy is manifested in the small traders, crafts and “survival activities”.
- The economy presents a low birth rate of companies associated to a high risk of failure.
- There are few “foreign investors – national investors” joint ventures.
- The small sector of liberal professions is an interesting target.
- The commercial sector appears to be unstable (numerous openings and closures – little ambition for growth). The handicrafts sector may hold promises.
- A limited number of industrial SMMEs is to be accompanied to enable them have productivity gains and support for growth.

- In the agricultural sector, the fate of small producers is to be improved upon through better infrastructure, storage – commercialization, enhancement of the value of output. Liquidity is very narrow and the sector precarious. Farmers’ organizations, although strong, face the stigma of banks.
 - A retail guarantee mechanism could be used for a variety of purposes: investment, working capital. Adding technical and commercial guarantees would be welcome (good performance of a contractual obligation, guarantees for public tenders, commitments vis-à-vis international cooperation institutions ...).
 - The group of customers targeted by the guarantee would consist of formal businesses, small and preferably medium-sized, already having a management experience, below bankability threshold. The size of their financial needs exceeds their capacity to provide the lender with sufficient collateral of their own, either they do not have any, or they have already committed them in previous credit transactions.
 - The reliability and the sincerity of the annual financial statements are questionable. It is preferable to have a double “lender + guarantor” review of most credit applications.
 - Key sectors would be: tourism in region A, outsourcing companies and subcontractors in port area B, services to enterprises and consumers in urban areas, companies capable of finding export opportunities. The guarantee segment of 20,000 to 100,000 is promising.
 - The agricultural sector would only be targeted in a limited and balanced proportion. In a first phase, it should not address the small producers themselves, but their purchasing and sales structures or production cooperatives. More focus should be on downstream production: enhancement of added-value and diversification.
-

3.2.2 The legal profile of the guarantee instrument

Issues related to the prudential supervision

Financial operators generally have a lot of confidence in banking supervisory mechanisms although the fact is not observed so consistently in developing countries.

Nevertheless, the prudential regulations required for a guarantee company are not fully compliant with the obligations made to other financial institutions:

- A first obstacle against the banking framework is that the minimum amount of equity required for a guarantee company may be lower than that necessary to launch a bank.
- Periodical banking reporting is quite long and complicated. The information management system of a guarantor may be less sophisticated.
- The banking leverage between assets and equity – 12.5 times, corresponding to a Risk Asset Ratio of 8 % – is too high even for a professional guarantor.
- Operational risks are lower in a guarantee company.

If a sui generis prudential regulation is envisaged, it should provide for:

- The rigorous definition of the SMMEs loans guarantee business and the protection of the denomination.
- The organs in charge of the approval and the composition of the application file:
- The evaluation criteria:
 - Statutory aspects: legal form of the company; limitation of the business to the guarantee service and financial counseling; non-profit character; shareholding; possible limitations of the voting power of majority stakeholders; the business plan assessing the sustainability of the company.
 - Organization chart; skills required of members of corporate bodies; corporate governance principles
 - Financial parameters: Minimum equity capital; maximum leverage Guarantee commitments/- own funds; liquidity and investment policies; risks provisioning policies; framework of accounting structure and evaluation rules of assets, liabilities, products and charges
- The prudential framework; its seat; field and desk due diligences; external auditor compulsory?; periodical reporting; obligation to submit reports prior to holding General Assemblies; corrective actions in case of disorder (rectify the situation?, reduce the level of activity?, modify policies ...); sanctions (publish information notices to stakeholders?, appointment of a special Commissioner?, resignation of the Board of Directors ...).

In other words, it is appropriate to know the opinion of the Central Bank and the Ministry of Finance.

Issues related to the articles of association and the shareholders:

According to the type of shareholding and the basic options made by partners, the choice is open between a corporation (joint stock company, limited liability company, public limited company) or a company owned and operated by businesses using the guarantee service for their mutual benefit (limited liability cooperative).

The choice is not neutral as it entails a number of consequences:

- Minimum equity: while the importance of adequate capitalization has been pointed out, it is clear that available means of cooperative members are often (too???) limited.
- Corporate bodies including the General Assembly, executive bodies (Board of Directors, Management Committee and a Credit Committee in charge of decision making on guarantee applications): cooperatives are dedicated to special values such as openness, social responsibility, decision making made by peers for peers ... with less (no) banking experience.
- Their respective legal framework does not give the same content / extend to their control procedures (internal control, external audit), their accounting systems, their financial statements and disclosures ...
- The particularities of each type of company and their incorporation formalities.

Stakeholders can propose various levels of partnership with the guarantee company:

1. **Partnership in Equity Capital:** in an ideal world, all stakeholders should become shareholders. This setting would give consistence and balance to the strategy and the operations. Far from that, a second best solution might be found in the views and statements collected during the market research. Who would be interested in an investment – even limited – in the project? What is the attitude of Banks? What is the position of the public sector (Ministry of Finance/Economy/

Development/ Development Bank? Is there a readiness and a sufficient financial capability within the field business tissue or its representative organizations to launch a mutual system.

2. Partnership in risks without participating in the shareholding: international organizations and donors could be expected to grant subsidies or subordinated loans because of the social character of a guarantee facility. They would increase the own funds without taking any shareholding responsibilities. Can the developers of the project count on them? How long would it take? Under what conditions?

3. Partnership in the functioning of the company:

- Entrepreneurial organizations can have various useful contributions: promotion of the scheme, recommendation to use its services, financial consultancy and counseling potential credit applicants, advice, participation as credit experts in the Commitments Committee ... But ... Do they understand the issues? Are they reliable persons for the job? Are they actually the voice of their members? Could they ease the process by good political connections
- Financial institutions can obviously bring a lot: monitoring to their clientele, advice to borrowers, fair cooperation in daily business but also in strategy definition, creation of financial products in which the guarantee instrument is involved, participation as credit experts in the Commitments Committee ... But ... Which are those that expressed an interest? What are their anticipations in terms of number and volume of guarantee applications? To what extent are they ready to change their credit strategy? How will they promote the instrument in their distribution network?
- Public authorities dispose of numerous tools that will greatly help the new scheme: tax exoneration on fees, on provision making, promotion by SMMs Agencies, insertion of the guarantee in SMMs support policies, subsidization of the guarantee fee charged to the beneficiary business, counter-guarantee of losses, administration subsidy ... But ... do they feel fine with a new financial instrument? Will they respect the principle of independency of the company?

Issues related to the personal guarantee as a loan collateral

- Does the personal guarantee rank as a legal credit collateral?
- In terms of credit negotiation, the bargaining power of the guarantee offered by a natural person is very limited. How about a professional guarantor?
- A delicate issue is raised by the existence of joint personal guarantees: that provided by a natural person (father for the son; director for his company ...) and that granted by a professional guarantor. Obviously, the wish of the latter is that both won't be put on the same footing: the professional wants its commitment to be subsidiary to other ones. Is that solution possible?
- Bankers may prefer the commitment of a guarantee company when it is accompanied by a deposit on a blocked account in their ledger. To be discussed rigorously ...
- Are courts diligent to handle bankruptcies and to take steps against their guarantors? What is the experience drawn on the enforcement of their decisions? Is their jurisprudence constant?
- Much attention must be paid to the drafting of the guarantee contract – and its general terms and conditions – to be concluded with the lenders and the borrowers.

Issues related to the tax system

- Are guarantee fees / application fees exonerated from indirect tax (VAT or others)?
- How does the Tax Administration handle risk provisions of financial instruments?
- What are the legal and administrative provisions concerning the corporate tax rate?

THEORETICAL EXAMPLE (CONTINUED)

Notes on legal issues and resolutions of promoters

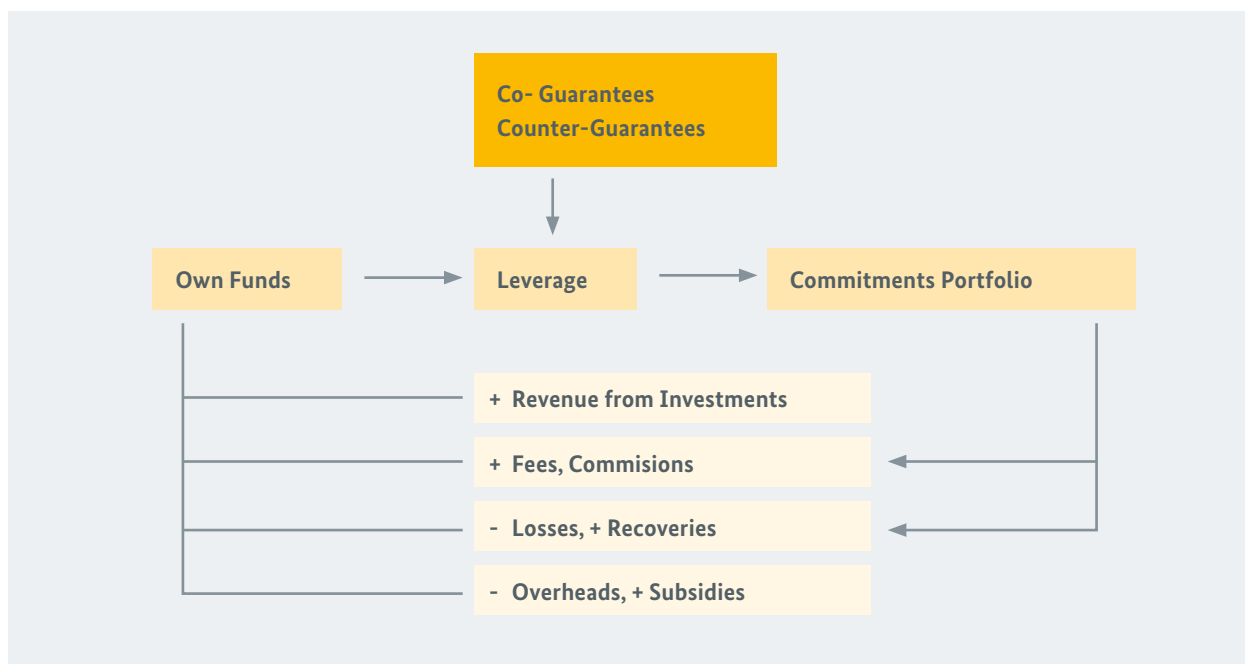
- Here, banking supervision is not adequate for a guarantee company. Passing a specific law while neither Ministers nor Parliament members know actually what is at stake, would be a delusion. Unfortunately, the company will have to find a suitable formula on its own. Developers opt for an “internal law” copied on a foreign model. It will be submitted to the National Association of Banks for approval. It provisions periodical audits performed by an external auditor. Fully independent regarding his mission, he will disclose every report in full to all partnering lending institutions. Each early signal of dysfunction allows banks to ask additional information and to cancel the contract.
 - Besides, the personal guarantee is well defined in the Commercial Code and fully compliant with a professional guarantee activity.
 - Company law helps to incorporate a limited liability company. Within the mutual option, there are doubts that enough capital can be collected. Developers will not envisage creating the company if at least a capital of 3 million Euros cannot be raised.
 - The Corporate tax rate is 20 %.
 - Fees will be tax free.
 - Provisions that are not backing certain and well defined losses are imposed. It is paramount to clarify this issue with tax authorities.
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3.3 Module 3: Size and solvency of the company

General purpose of the module:

The third part is another step further and a crucial stage as well. Developers have made the choice of the main guiding principles. They are now able to focus on two elements that result in a model presentable to investment partners and discussable with them: the size of the company and its sustainability

The analysis of the parameters and their interactions occurs in a static view: when the company has reached a cruising speed.



3.3.1 Relationship between portfolio and own funds

Own funds, equity capital

- Their amount must be high enough to build trust with business partners and to reach a sufficient threshold of commitments portfolio. From this general observation and without prejudice to particularities related to the size of the underlying economy, we will consider that it is futile to envisage a start-up capital of less than 5 to 8 million Euros for a medium-sized economy on the road to development.

- Moreover, their investment should generate financial income covering a substantial part of the operating costs. A “rule of the thumb” is that income drawn from guarantee transactions should not subsidize operating costs (which should be borne by financial investment income).

- Can equity capital be increased over time along with the development of the activity? In theory, the answer is yes, but in real life, the process is not that easy. Actually, existing shareholders are reluctant to open the gates to new partners as the new situation can disrupt the balance of powers and create tensions. It is often preferable to overestimate the initial amount of own funds with regard to the initial needs and defer the release of a second call. A shareholders' agreement can be concluded to settle the procedures for a subsequent release.

The leverage (Outstanding volume of guarantees commitments / Own funds):

- **General principle:** a realistic leverage for a “retail” type guarantee company is 3 in its start-up phase and in a time horizon of 3 years. It seems wise to stabilize this value for another year or two before the Board would then validate new policies with a further objective of 5.
 - The more policies will be permeable to riskier transactions ... the higher commitments on the same recipient will be accepted ... the more risks will be concentrated in the same sector, and the more conservative the leverage objective ought to be.
 - High leverage and high risks can only be compensated by higher fees. Higher fees will divert good clients from calling the support of the guarantee ...
 - Experience shows that something like a leverage of 7 is the benchmark for a mature system in a mature financial economy.
- **Incidentally,** a leverage of 7 is much below the maximum extent of the assets (12.5 x) of a financial institution due to comply with a prudential risk assets ratio of 8 %. This reflects the more risky character of the SMMEs sector. It also points out the necessity of a prudent management.

- **Some sophistication:** some guarantee schemes differentiate the leverage according to pools of guarantees associated to different probabilities of default. A number of “equity windows” will then be backing riskier (e.g. start-up enterprises...) or softer (e.g. technical guarantees) commitments.
- **Type of guarantee:** when the final loss of the guarantor is calculated on the remaining amount compensated by recoveries made on the debtor pledged assets (loss sharing type), the leverage can be set at a more comfortable level. A more prudent policy is required when the guarantor is fully liable of the gross protected amount before collateral recovery.

- **Counter-guarantees:** the contribution of a counter-guarantor that would share the losses fifty/ fifty with the main guarantor allows the latter to double his leverage without running more risks.

The guarantees portfolio (volume, diversification and quality):

- Behind the setting of the leverage, the question is “How many applications and what volume of credits are financial institutions able to introduce to the guarantee agency in the next 12 months?” Ideally, the additional portfolio should express the additionality of a guarantee instrument by a “sufficient but not excessive” growth of the banks portfolios... Optimistic expectations at a rapidly obtained leverage of 3 are an invitation to review the equity amount. Obviously, the size of the internal market and the SMMEs structure condition the hypotheses made about the portfolio volume.
- Exploring the possible portfolio diversification and granularity is an interesting avenue of reflection to share with those who will feed the business.
- Finally, it is very important to get an idea of the possible quality of the portfolio. The current rates of loss faced by lenders on average quality credits are useful data. This is because the loss probability will have to be integrated in the determination of the fee. Realistic opinions will serve the reliability of the sustainability scenario.

3.3.2 Review of the P&L account, sustainability of the project

Long term sustainability is the guiding principle which, in the guarantee system, replaces the profitability objective for a common enterprise of the private sector. The concept derives from the duality of being both a social purpose entity belonging to the financial sector.



This stage consists of a desk analysis reviewing all aspects of the project that condition revenues and charges. Various combinations are possible. The purpose is to form a suitable mix that is compatible with the market characteristics, with the prevailing economic situation and that balances the P&L in a realistic manner.

The reasoning envisages:

- a business that has reached its cruising speed. It goes about a static view and not a dynamic business plan.
- the sensibility of each parameter considering that the market is not familiar with the instrument, and the elasticity of their interactions (additionality, leverage, loss ratio, fee rates ...);
- a realistic estimate of the operating profit before provisions, depreciations and taxes (EBITDA).

This stage requires rigorous methods, realistic assumptions and accurate calculations. As such it is an opportunity to detect wrong hypotheses, to refine the model and to prepare the dynamic view that will form the final business plan.

Financial income

- The amount available for cash investment is equal to the own funds less investments in fixed assets and less precautionary cash in hand,
- Incomes depend of the market interest rate, the inflation and the risk of a currency devaluation,
- Diversification among various savings products is recommended.

Incomes generated by the guarantee business

Many basic variables influence this window: the coverage percentage of the underlying credit (e.g. 50 %, 80 %); the annual fee rate; the procedure of collecting the fee (front-off payment, annual payment); additional commissions charged to the debtor (e.g. application fee, management fee)

- The guarantee fee is the main element. It is adaptive.¹⁰⁹ Either it is a fixed %age equal for all beneficiaries; or it varies case by case with the assumed probability of loss. Either it is equal for all transactions or it varies according to the guarantee product (a portfolio guarantee, a “start-up” retail guarantee, a performance bond guarantee...)
- Other incomes are a possible application fee and an annual management commission.
- Public support policies can take a prominent part in the setting of fees, when a counter-guarantee is put in place or when the fee is subsidized by public money.
- How is the guarantee defined? A “final loss sharing” is much more favorable than a “joint and several with the banker”; a coverage “principal only” is less risky than a “Principal + unpaid interests and costs” coverage.
- The ability to take effective recovery action is likewise dependant of external constraints (hence the speed and security of court actions, the existence of a deep enough second-hand market) for resale on seizure, but also of own policies and procedures (e.g. cooperation with the lender for lawsuits against unlucky debtors, the possibility of being subrogated in the banker’s rights and being able to carry on prosecution actions for the guarantor’s sole account when the credit institution is negligent...)
- Counter-guarantee mechanisms are there to absorb a part of the loss and to benefit of a part of the recoveries.

Losses and recoveries

- Expected losses are related not only with external conditions (macro-economic situation, business cycle, economy-wide fluctuations), but also and mainly to the strategy of the scheme.
- In this respect, the P&L account will be impacted by the selection of target sectors, the accepted maturity of the guarantee supply (short term, less risk), the granularity of the portfolio (many small guarantees or few big clients), the targeted additionality effect (the more one offers incentives to lend and to borrow, the more lenders will relax their decision criteria)
- Not to forget is the quality of the credit- guarantee chain: counseling the SMME applicant, establishing a fair partnership between the lender and the guarantor, disposing of quality decision making systems and bodies, monitoring of a client potentially in danger.
- Operating costs
- The organizational structure requires 6 to 10 officers and employees at full fledge. A softer structure in the launch phase will grow over time,
- As to rental, accommodation of the company in the developer’s buildings can spare costs, as well as a centralized (a head office only) or decentralized (several regional offices) organization,
- Processing costs height are linked with computerization of the information management process -back-office, accounting, and reporting- , with optimization of communications with lenders (frequency of periodical reports //paper work or secured computer technology),
- Marketing costs can be shared with banks (marketing campaigns in common, creation of specific products with a guarantee element) and with federations of entrepreneurs (information to their members through their own communication tools). They may not be underestimated.

¹⁰⁹ see chapter 2.6

- Public support can alleviate the cost burden (Tax system, functioning subsidies in the company launch phase)

THEORETICAL EXAMPLE (CONTINUED)

Once more, the example is synthetic. Simplification can make things look not fully realistic. The purpose is to play with various guarantee systems and with various modalities.

The findings below are those that the developer would be about to submit to partners. In the next phase, the latter will be free to suggest comments and amendments before committing themselves.

It is reminded that the sustainability approach is obtained in a static view, at cruising speed.

1. First approach to the capital

- Given the size of the market and the need of a robust and trustful tool, a start-up capital of 7 million would be required, backing, at full fledge a guarantees portfolio of 35 million.
- With an average guarantee rate of 60 % of the underlying loans, the activity would underpin about 60 million credits, that is 12 % of current outstanding SMMEs bank loans. The objective seems attainable with a reasonable additionality, and without running unaffordable credit risks.
- The initial capital call will levy 5 million, while the additional 2 million shall be paid-up in due time according to the growth of the activities as it will be ascertained by the shareholders' cooperation charter.

- Out of the 5 million paid-up capital, 4 million will be invested in financial products generating an annual interest income of about 150,000.

2. Portfolio approach and leverages proposed by the developers

The project will be split in 2 windows

a) "Microfinance funding" window

The project envisages to extend a wholesale guarantee to a microlending institution. It will enable the institution to borrow 10,000,000 to use as additional funding means.

Subject to a thorough diligence of the beneficiary, the risk of the guarantor appears limited because this additional funding would be diluted in a current mattress of own funds of 12 million made of capital and donations.

What is more, the institution being involved only in lending transactions, its ratio of indebtedness is not exceeding 1/1 and its know-how is proved by experience.

With a leverage of 5 times, this window will block 2 million equity capital.

The guarantee generates the following additionality:

- It provides a strong incentive to financiers to lend in contained risk conditions.
- The interest rate of the loan will drop by 100 basis points.
- The funding will be available for micro credits to the informal economy, which is largely underfunded.
- The operation strengthens the synergy between the micro-financiers' and financial markets.

Key data:

- Volume: 10,000,000
- Duration: 5 years
- Guarantee fee: 0.5 %
- Risks:

- **Probability of loss:** limited. To be on guard, on top of a thorough due diligence, the guarantor will proceed to regular monitoring. In case of default by the debtors of the microlending institution, recovery can still be operated on a capital base of 12 million
- **Special risk:** Liquidity of the guarantee institution in case of a call by the lender.
- **Call in of the guarantee:** straight and timely payment to the lender

b) "Retail loss sharing guarantee" window

The residual amount of equity (3 million) is a mattress serving direct or indirect guarantees to SMMEs.

- In a conservative pilot phase, the portfolio objective is 9,000,000 (leverage 3 times) in a time span of 4 years. The intention is to stabilize the activity at this level for another 2 years before reviewing the sustainability with a leverage of 5 times.
- In the SMMEs market, 3 segments are envisaged:



A. A “portfolio” guarantee granted to two microfinance institutions.

Through the portfolio system, their credit committees would be trusted (no duplication of credit assessment) but a common framework of acceptance criteria will be set. The coverage will bear on a pool of deals up to a contractual amount. Case by case information and periodic reports will ensure transparent communications.

The intended additionality is to enable the micro-financier to grant larger loan amounts and to extend the maturity for the benefit of customers nearing “bankability” threshold.

Key data:

- Volume: 500,000
- Maturity: 2 years
- Rate of cover of loans: 50 %
- Gall in of the guarantee: on default, case by case, timely payment after full completion of the lenders’ own obligations.
- Fee rate: 2 %.
- Probability of loss: 2 %
- Possibilities of recoveries from debtors in default: low or zero.

B. A second portfolio as direct final loss sharing guarantees to formal enterprises, for investment and working capital credits.

The objective of additionality consists of promoting promising development sectors; improving access to equipment loans and bank overdraft for those whose bankability is “below the line”, helping banks to address a new clientele ... with subsequent positive macroeconomic benefits.

Key data:

- Volume: 8 million (6 in term loans + 2 in overdraft)
- Average duration: 4 years for term loans (from 2 years to 5 years, and 1 year working capital)
- Rate of protection of underlying loans: 75 % for investments and 50 % for working capital loans.
- Implementation of the guarantee: 30 % provisioning in case of thirty days lateness in contractual payments; 100 % when 60 days. The guarantor is ready to pay off the lender at his first call insofar, on his side, the lender has initiated recovery actions against the defaulted borrower.
- Fee rate: 2.8 % (borne by the borrower, but paid by the lender from the loan amount)
- Other fees: none
- Probability of loss: 2.8 % (that is 1.8 % more than the current stated loss rate in the banking sector)
- Assumptions of recoveries: average 40 % of the credit amount at default. Recovered amounts benefits to both in the proportion of their risk sharing The guarantor will contribute to the costs of legal proceedings.

C A third portfolio of direct technical / performance guarantees to SMMEs

The additionality is to allow mostly middle-sized businesses to access new trade markets (including public tenders) and engage in solid commercial transactions encumbering their credit lines.

The guarantor considers this segment as a “commercial” one with incomes balancing costs.

Key data:

- Volume: 500,000
- Maturity from 6 months to 1 year
- Rate of protection of the contractual counterpart: 100 (insurance principle)

- Call in of the guarantee: compensation is paid at first demand when the condition of the contract to invoke the guarantee is met.
- Average fee rate: 1 % (can be set case by case)
- Probability of loss: 0.5 %
- Possibility of recovery from customer in default: the customer will give some soft collateral to the guarantor (at least, some pressure on the customer to provide some collateral)

3. First approach of costs by the promoter

Estimated total operating costs: 160,000 Euros (say, 6 employees)

4. First approach to the sustainability of the project in a static view and at cruising regime

Financial income:		150,000
Window 1, fees:	(10,000,000 x 0.5%)	50,000
Window 2, portfolio 1, fees:	1 (500,000 x 1%)	10,000
Window 2, portfolio 2, fees:	(8,000,000 x 1.8%)	224,000
Window 2, portfolio 3, fees:	(500,000 x 1%)	5,000
Total income:		439,000
Operating costs		160,000
Available cash flow for provisions, payment of losses, taxes:		279,000
Estimated losses:		
Window 1:???	(strong chances of success)	
Window 2, Portfolio 1:	(500,000 x 1%)	10,000
Window 2, portfolio 2:	(8,000,000 x 1.8%)	224,000
Window 2, portfolio 3:	(500,000 x 0.5%)	2,500

Notes:

- The company will take the legal form of a limited liability company. Shareholders will be both public and private (lenders and a business association).
- The government proposes to take the guarantee on board of its support policies.

Taking into account the social role of the instrument, the proposal is to consider the tax exoneration of the general risk provisions insofar no dividend is distributed and such provisions are a buffer for future credit losses.

Even if the public sector would be a majority shareholder, public and private partners shall manage the company on equal footing (number of seats in the Board).

The Credit Committee, composed of experts, will be able to make decisions in full autonomy.

Weaknesses and unsolved issues:

- symbolic participation in capital of the 2 microfinance companies?
 - Could beneficiary entrepreneurs be requested to purchase a very thin share of capital as a path to mutualism? (shares to be transferred to them by public shareholders at face value)
 - The guarantee service to be delivered only to those lenders which will become shareholders?
 - Try to involve international donors?
 - Proposing a “voluntary” prudential system that compensates the lack of legislation in place has not the adhesion of the Central Bank.
 - Consulting with some well established guarantee companies or acknowledged consultants about the project and the business plan?
 - Deepening market research on selected market niches refining default and recovery hypotheses? Hypotheses taken by developers are fragile.
-

3.4 Module 4: The foundation of the guarantee company

General purpose of the module:

- Time has come to have a second meetings round with the founders and partners with an accurate market approach and a sufficient financial perspective.
- Their comments, their feed-back and their consensus are key to turn the draft into a feasible project on which a commitment is expected. They are requested to scrutinize the proposal, to point-out on unrealistic hypotheses, unreachable objectives, omissions and errors.
- The review of parameters is done through a sensitivity analysis with field experience.
- With their professional knowledge of the guarantee, the role of developers is to analyse any consequence born by changing the value of a parameter (e.g. the assumed loan loss rate).
- In doing so, the community of stakeholders validates the performance, the solvency and the sustainability of the facility.
- The work identifies the shareholders and their respective contribution.
- It leads to a dynamic business plan.
- It also results in a solid outline of articles of association, organization chart and governance principles.
- It prepares the documentation and files to be submitted to the prudential supervisor.
- It sharpens the strategic and technical options that will eventually be transformed into operational manuals.

3.4.1 Sustainability and sensitivity study

The solvency and sustainability analysis stopped at a static view based on key parameters estimated by the developers on views collected in the market research. It ended by a description of its market effectiveness and a rough evaluation of the financial performance.

The intention of the working group composed of high level managers is to create scenarios and, after several iterations, to validate in good agreement the best possible mix of criteria and parameters in a dynamic perspective. Partners are first asked to express an agreement on the basic assumptions of the creditworthiness-sustainability analysis.

THEORETICAL EXAMPLE (CONTINUED)

The experts working group is invited to review the strategic market and the financial options. All ideas are carefully noted and discussed as they eventually change the basic plan.

This phase strives to compile financial statements over a projection horizon.

The table below shows the amended plan:

Hypotheses:				
Targets	Microfinance Institution addressing the informal economy	Informal Micro-enterprises on the edge of bankability	Formal enterprises (0 to 50 workers, all sectors with some priorities)	Formal enterprises (10 to 250 workers, case by case selection)
Projects supported	Increasing the funding 8 million/ 5 years / bullet payment.	Microcredits (mainly for investment in stocks and equipment)	Leasings + bank Credits max 250,000 (both for investment and working capital)	Technical and commercial guarantees- max 100,000 per beneficiary
Recipient's disposable collateral	nil	Solidarity groups	Inadequate real assets + others according to lender	Personal joint personal guarantees
Types of guarantee	"wholesaler" with 1 million in blocked account 1st and 2nd instalment capped	"Portfolio" with criteria framework, 50/50 % loss sharing, case by case indemnification	"Retail", with double credit review, 75/25 and 50/50 loss sharing, case by case	"Retail" with direct checking, 100 % on first request according to underlying contract
Event triggering the indemnification of the beneficiary	Inability of the micro-financier to repay the advance received from the lender.	Insolvency of the debtor and loss for the lender, acted, and provisioned	Insolvency, bankruptcy of the borrower	Non/ mal- execution of contract, failure of the project, debtor not insolvent
Additionality of these shares	Saturation of the funding, Development of credit toward the informal sector	Improving size and duration of credits for nearly bankable informal entrepreneurs	Access to liquidity, investment credits with inadequate/ insufficient collateral	Access to public procurement, outsourcing, technical guarantees

New parameters and consequences of the changes:

Parameter	Expected value	Impact of a change
Equity capital	5 million paid-up	If less capital: Little credibility of the institution, Insufficient portfolio size / diversity, Little financial income
Leverage	3.8 x (average between 3x for portfolios 2, 3, 4 to 4x for portfolio1)	If lower leverage: Ineffectiveness of the instrument but trust If too high leverage at the launching phase: Risk, disrupted learning, little confidence
Coverage rate Window 1 (microfinance funding)	1 million senior to 100 % 9 million in loss sharing capped at 1 million loss	If protection is increased: 5 years high risk term, paralyzing other windows If protection is decreased: no additionality, unuseful, not marketable.
Coverage rate Window 2, Portf 1 (microcredit portfolio)	50 % in loss sharing, without double decision by both 2 partners	If lower rate: little usefulness If higher rate: risk of adverse selection 50 % = fair partnership
Coverage rate Window 2, Portf 2 (formal SMMEs portfolio)	75 % / 3 years for investment credits 50 % / 1 year for liquidity 50 % / 3 years for leasing	High rates, but loss sharing! ... Reasonable duration ... If lower rate: lenders not interested If higher rate: too risky
Coverage rate Window 2, Pf 3 (technical guar)	100 % compensation on first request if project is not executed	Rate inherent in the type of project Prosecution against not bankrupt entrepreneur that pledges some securities according to risk
Fee rate Window 1 (microfinance funding)	0.5 % per annum on guaranteed outstanding amount. Probability of default (PD) = 1 %	Very limited fee and five years horizon, but <ul style="list-style-type: none"> ■ prior thorough screening + monitoring ■ recipient earns 100 b.p. on his funding , ■ possible recovery on partly “sound” credit portfolio
Fee rate Window 2, Pf 1 (microcredits portfolio)	2 % per annum on guaranteed outstanding amount	Average PD of the microfinancier = 2 % but the guaranteed portfolio takes the cream of the customers base Balanced results expected. Normal rate ...
Fee rate Window 2, Pf 2 (formal SMMEs portfolio)	2.8 % / per annum, front off on duration and guaranteed outstanding amount PD: ?? ... 3 %? Application fee: 0.3 %	Subsidization operation. Hope that loss-sharing avoids adverse selection If less commission: unbearable losses Higher commission: good customers shy away

Fee rate Window 2, Pf 3 (Technical guar portfolio)	1 % /per annum front off Application fee: 0.5 % PD: 0.8 % (?)	Insurance-type portfolio with limited “social goal” We cover technical risk on a sufficient financial basis and with soft collateral on surviving businesses after call to guarantee
Ceilings Window 1 (micro- finance funding)	Global: 10 millions Backing assets: 2 millions	Leverage 5 x / 1 beneficiary If total loss, equity reduced to 3 million, liquidity at stake
Ceilings Window 2, Pf 1 (microcr. Portf.)	Global: 500,000 Max per deal: 2,000 Average: 2,000	Leverage 3 x after 4 years Good granularity (pot. 200 clients) Good sectoral diversification.
Ceilings Window 2, Pf 2 (formal SMMEs portfolio)	Global 8,000,000 Max per deal: 100,000 Average 30,000	Leverage 3x after 4 years Sufficient diversification with sectoral framework
Ceilings Window 2, Pf 3 (Technical guar portfolio)	Global: 500,000 Max per deal: 100,000 Average: 30,000	Leverage 3x, quicker than 4 years Fewer market opportunities, little diversification Consider good risk with low PD
Loss recovery, debt collection	Limited, very conservative	<ul style="list-style-type: none"> ■ Possible on portfolio 4 ■ Loss sharing guarantees in portfolios 2, 3
Financial income	3 to 4 % out of 90 % of the equity capital	Without that revenue, overhead costs = burden
Overhead cost	160,000 to 230,000	Need for minimal structure Progressive recruitment possible
Other activities	nil	Opportunities to be further explored: accompaniment ... against a fee? training and education ... against a fee?
Public support at this stage?	nil	Opportunities to be further explored: Functioning subsidies Subsidizing the guarantee fee Public counter-guarantees

THEORETICAL EXAMPLE (CONTINUATION AND DEVELOPMENT OF THE FINAL BUSINESS PLAN)

Financial income

Financial revenues will amount to 180,000, given a market interest rate of 4 %, diversified and low risk profile products and an invested amount of 4.5 million.

Balance financial income and running costs

In the first year, costs will be contained at 120,000 Euros. They will move up to 230,000 Euros in year 4 (additional jobs). In year 3, a new fee will be charged upon the applications “Formal SMMEs” and “Technical Guarantees”.

First window “microfinance funding” (wholesale guarantee to a microlending institution)

- **Maximum outstanding amount:** 10 million, 5 years, bullet repayment after 5 years.
- **Equity support:** 2 million
- **Leverage:** 5 times.
- **Guarantee model:** The experts working group made suggestions for this transaction of a particular type: they accept to cover at 100 % a up-front loss of 1,000,000. If the loss of the lender should exceed that amount, they propose a 50/50 % intervention jointly with the lender up to a max threshold of 2 000 000. Both will be subrogated in the micro-financier’s rights to recover their loss on the repayments to come from the microcreditis portfolio; first recoveries will benefit to the lender. At the request of the lender, 1,000,000 could be blocked on a deposit account in his books.
- **Due diligence:** the guarantee will be issued to the microfinance institution upon positive conclusions made on its profitability, its ability to monitor loans and clients, the accuracy of its reports, the marketing, the current probability of default of its clientele.
- **Guarantee fee:** 0.6 % per annum calculated on the outstanding guarantee commitment

- **Guarantee fee payment:** annual.
- **Presumed revenue generated as premium:** 60,000. No commission or document fee.
- **Risk of loss:** limited, but regular monitoring.
- **Provisioning of risk:** none if a 1,000,000 deposit has been made in the lender’s books

Second window:

- **Maximum outstanding amount after 5 years:** 9,000,000
- **Support equity:** 3 million
- **Leverage:** 3 times

Second window, portfolio 1 (micro-credits)

- **Maximum outstanding amount:** 500,000, 5 years.
- **Monitoring:** the guarantee will be validly committed by the sole decision of the microfinanciers. Upon timely notification, the guarantor registers the commitment.
- The guarantee will only be valid under the following conditions:
 - the loan recipient has already ensured the timely repayment of two advances,
 - the credit aims at investment in tools and equipment, with a maximum of 3,000 Euros and duration of 3 years per operation
- **Loss sharing:** the loss will be shared 50/50.
- **Dynamic hypothesis:** the portfolio will be used in full in the next 12 months.
- **General provisioning of the portfolio:** 0.5 % of the outstanding amount.

- **Individual provisioning of any single credit in difficulty:** respectively 30 % and 70 % of the unpaid outstanding in case of 30 and 60 days past due
- **Other data:** the experts working group confirms the developer's assumption (3.3.2)

Second window, portfolio 2 (direct guarantees to SMMEs)

- **Maximum outstanding amount:** 8 million
 - **Underlying operations:** investment loans and leasing accounting for 75 % of the portfolio (6 Million) and bank overdrafts (25 % = 2 million) mainly for priority sectors.
 - **Payment of the guarantee fee:** front-off, in advance in full, borne by the customer and paid by the banker for which he is responsible
 - **Relationship with lenders and risk provisioning:**
 - quarterly reports on the portfolio + annual detailed report
 - case by case report on past due amounts: first warning when a debtor is late by 30 days (provisioning of 30 % and in average 7 % of the customers are in this situation) then warning of 60 days lateness (100 % of provisioning and 2 % of the customers are in this situation).
 - provisional indemnification of the lender at 100 % of the guarantor's loss share as soon as the lender has denounced the credit contract and has initiated court action against debtor.
- a) Investment loans**
- Duration of underlying credits: max. 4 years // average 4 years (simplification):
 - Amount of underlying credits: maximum credit amount: 90,000 per client (= 3 % of a 3 million dedicated equity) // average amount: 40,000
 - Simulation of loans repayment programme: linear quarterly instalments, over 4 years (T0: 40,000 / T1: 37,500 / T2: 35,000 / T3: 32,750 T15: 2,500 / T16: 0)
 - Max and average rate of protection of the credit: 75 % (simplification)
 - Average composition of the portfolio in cruising speed 150 deals (= minimum to obtain a sufficient diversification)
 - Planning: total amount granted each quarter: 800,000 (20 credits) generating an outstanding amount of 2,700,000 at the end of the first year /Afterwards: year 2: 4,600,000/year 3: 5,700,000/year 4: 6,000,000
 - Number of possible operations granted per annum: 4 quarters of 20 operations = 80
 - Application fee starting from the 3rd year: 0.5 % x 3,200,000 = 16,000
 - Probability of loss: 2.8 % /year on the outstanding amount (or +/- 1.8 % more than the current performance of banks, allowing an expansion of the customer group). This rate is acceptable for fixing an acceptable guarantee fee.
 - Guarantee commission: 2.8 % per annum
 - Possibilities of recoveries after default: 40 % collected on average 3 years after the credit denunciation.

b) Working capital loans

- Duration: max and average: 1 year.
- Respective credit and guarantee amounts: 10,000 ; 5,000
- Max and average rate of protection of the lender: 50 %
- Composition of the portfolio at cruising speed: 200 credits
- Planning: 1st year: 500,000 (50 credits); year 2: 1,000,000 / 1,500,000 in the 3rd year and 2 000 000 in the 4th year
- Guarantee fee: 3 % / year
- Application fee: 0.5 % or 15,000 in the 3rd year, then 20,000 in the 4th year
- Probability of loss: 2.5 to 3 % / year on the outstanding amount.
- Possibilities of recoveries after default: 25 % received 3 years after the disaster

Second window, portfolio 3 (Technical and performance guarantees)

- **Maximum outstanding amount:** 500,000
- **Underlying operations:** individual operations will have a maximum of 90,000 Euros per client (= 3 % equity of 3 million) and one year duration/in average: 52,000/1 year
- **Protection offered to the beneficiary:** 100 %.
- **Average composition of the portfolio:** 20 on-going operations
- **Possibilities of granting** 20 operations per annum.

- **Criteria of decision:** existing firms, middle-sized, creditworthy customers, technically able to perform the service for which a guarantee is required.
 - **Collateral required from the customer:** small but some (based on risk)
 - **Application fee:** 0.5 % or 2,500 / year
 - **Guarantee fee:** 1 %, or 5,000 / year
 - **Planning:** the portfolio is fully utilized from the 1st year.
 - **Probability of loss:** limited, consistent with current banking market.
 - **Provisioning:** immediate 50,000 Euros.
 - **Payment of a claim:** Customer did not perform his contractual obligations. Counterpart claims for payment after summons to the main obligor
 - **Recovery rate after default:** estimate of 25 % recovered 2 years after recovery action against the customer based on the collateral pledged and the subrogation in the counterpart rights.
-

3.4.2 Alternative and worst cases scenarios

How would the situation be impacted by a decision of authorities supporting the scheme ...

- In the form of operating subsidies
- In the form of counter-guarantees of loss
- In the form of subsidization of the guarantee fee paid by the beneficiary

What will happen if ...

- The financial revenues would drop under the expected rate,
- The fee level went up 10 %/down 10 %,
- The loss rate on the outstanding amounts “direct guarantee to SMMEs” stands respectively at 2 % – 3 % – 5 %,
- The loss rate in the portfolio “micro-credits” stands respectively at 1 % – 2.5 % – 4 %,
- The loss rate on outstanding amounts of “technical and commercial guarantees” stands respectively at 1 % – 2 % – 4 %,
- Operating costs would increase by 10 % ... 20 %?

3.4.3 Impact of the guarantee company

In preparation of the final meetings round that would result in the commitment of stakeholders to recognize the scheme and to co-operate, it is useful to have arguments describing the positive impact of the facility. Now, developers are far from theory and they can quantify their assertions.

Facts and figures have been validated by an experts working group and take an actual significance.

But developers must remain humble and open to critics, ready to amend the project again and to test a new unexpected scenario.

3.4.4 Dynamic analysis

The static financial position prepared by developers in module 3 and the suggestions made by the experts working group provide a basis for a dynamic business plan and revised financial statements.

Beforehand, the authors must agree on a number of hypotheses:

- The scenario: neither too optimistic, nor too pessimistic, it will reflect the prevalent economic climate ... while keeping in mind the potential consequences of worst cases scenarios.
- The horizon: forecasting the activity of a guarantee company needs to consider a time horizon of 8 years. It is usual to take 4 years before full-fledge and to observe the result on a second revolving period (by just stabilizing the data).
- Splitting the forecast horizon into periods: it is clearer to cut the first year in 4 quarters and to move afterwards to annual records.
- Probabilities of loss. It is necessary to consider immediately in full the average loss rate retained by the experts working group.

Proceeding order: The **simulation** is done by recording successively: the off-balance accounts, the general risk provision allowances and the individual loss-provisioning; the cash accounts and investments opportunities; the profit and loss accounts; and finally the balance sheet.

THEORETICAL EXAMPLE

Off-balance-sheet records

Guarantee commitments are broken down by remaining maturity, guarantee product, by lender, by category of clientele (start-ups vs existing enterprises) and any category that makes sense for a sensitivity analysis.

The highest importance is given to pools of deals broken down by quality:

- category A: good customers (timely repayment of their credit obligations as reported by lenders)
- category B: arrears of payment of 30 to 60 days on contractual credit obligations
- category C: customers in arrears of payment of 60 to 90 days
- category D: impaired credits and lenders not yet indemnified
- Losses: provisional payment made, on-going recovery process
- Liquidated guarantees: final settlement after recovery process. Written-off commitments

Items	Year 1	Year 2	Year 3	Year 4
Monetary value				
Window 1	10,000,000	10,000,000	10,000,000	10,000,000
Portfolio 2 A (micro-credits)	500,000	500,000	500,000	500,000
Portfolio 2 B (direct SME investment)	2,700,000	4,600,000	5,700,000	6,000,000
Portfolio 2 B (SME working capital)	500,000	1,000,000	1,500,000	2,000,000
Portfolio 2 C (SME technical gar)	500,000	500,000	500,000	500,000
TOTAL	14,200,000	16,600,000	18,200,000	19,000,000
Quality of window 1				
■ A (without individual provision)	10,000,000	10,000,000	10,000,000	10,000,000
Quality of portfolio 2.A.				
■ A (without individual provision)	490,000	490,000	490,000	490,000
■ Indemnified guarantees	10,000	10,000	10,000	10,000
■ Written-off guarantees (for information)		(10,000)	(15,000)	(20,000)
Quality of portfolio 2.B.				
■ A (without individual provision)	2,950,000	6,091,000	6,646,500	7,270,000
■ Substandard (7 % of the portfolio)	329,000	392,000	504,000	560,000
■ Indemnified guarantees (3 % of the portfolio)	88,500	182,730	199,400	218,100
■ Written-off guarantees (for info ...)	-	(88,500)	(271,230)	(489,330)
Quality of portfolio 2.C.				
■ A (without individual provision)	497,500	497,500	497,500	497,500
■ Default (provision 100 %)	2,500	2,500	2,500	2,500
■ Indemnified guarantees (prov at 100 % of T-1)		2,500	2,500	2,500
■ Written-off guarantees (for information)		-	(5,000)	(7,500)
Other subdivisions, by region, sector

Profit and loss account

	Year 1	Year 2	Year 3	Year 4
Financial revenues	180,000	180,000	180,000	180,000
Guarantee fee				
Microfin. Funding Portfolio	60,000	60,000	60,000	60,000
Microfin Portfolio	10,000	10,000	10,000	10,000
SME Direct Portfolio*	117,600	158,800	204,600	228,000
SME Technical Portfolio	5,000	5,000	5,000	5,000
Application fee	2,500	2,500	18,500	18,500
Recovery of individual provisions for risk			30,000	
Recoveries of losses	-	-	-	16,000
Subsidies, contributions of donors	-	-	-	-
Total revenues	375,100	416,300	478,100	501,500
Operating costs	120,000	170,000	170,000	230,000
- EBITDA	255,100	246,300	308,100	271,500
Depreciation of fixed assets	10,000	5,000	5,000	5,000
Risk Provisioning				
■ Window 1	-	-	-	-
■ Portfolio 2 A	2,500	2,500	2,500	2,500
■ Portfolio 2 B (30 % of arrears)	98,700	18,900	33,600	16,800
■ Portfolio 2 C	50,000	-	30,000	-
Losses				
■ Window 1	-	-	-	-
■ Portfolio 2 A	10,000	10,000	10,000	10,000
■ Portfolio 2 B*	117,600	158,800	204,600	228,000
■ Portfolio 2 C	2,500	2,500	32,500	2,500
Duties and taxes	-	2,400	10,000	1,500
Profit (+) Loss (-)	-36,200	+46,200	+ 9,900	+5,200

* the fee rate has been set at the assumed loss probability (2.8 %, cf. page 102 above)

Balance sheet

	Year 1	Year 2	Year 3	Year 4
LIABILITIES				
Payable Short Term	10,000	10,000	10,000	10,000
Other liabilities				
Individualized risk provisions	101,200	122,600	158,700	178,000
Other provisions (fiscal, Corporate)	-	2,400	10,000	1,500
Non individualized (general) risk provisions	50,000	50,000	50,000	50,000
Total				
General risks fund		9,000	17,900	22,100
Paid-up capital	5,000,000	5,000,000	5,000,000	5,000,000
Reserves		1,000	2,000	3,000
Profit brought forward	-36,200	0*	0	
Total Liabilities	5,125,000	5,195,000	5,248,600	5,264,600
ASSETS				
Cash in hand	255,000	435,000	543,600	564,600
Blocked deposit account (“funding” guarantee)	1,000,000	1,000,000	1,000,000	1,000,000
Investments Short term	300,000	200,000	150,000	150,000
Investments at M and LT	3,500,000	3,500,000	3,500,000	3,500,000
Receivable	10,000	10,000	10,000	10,000
Net fixed assets	60,000	50,000	45,000	40,000
Total Assets	5,125,000	5,195,000	5,248,600	5,264,600

Notes related to the P&L:

- A front-off bulk payment of the fee is recorded in the provision accounts; annual portions of it are credited in P&L in line with the amortization schedule of the guarantee commitment.
- Assumption of loss recoveries (e.g. 10 % received 2 years after payment of compensation)
- Level of salaries? Number of employees on the pay-roll

- Board of Directors and Decision Committee: amount of the attendance fees?

Consultation with the supervisor

The business plan is submitted to the prudential supervisor.

* The profit of 46.200 of year 2 has been used to balance the loss carry-forward (36.200) from year 1, the establishment of reserves (1000) and the general risks fund (9000)

THEORETICAL EXAMPLE

In the economy in question, the finding was that banking regulation was inapplicable and that it was vain to obtain from authorities a supervision system that would make sense.

The founders provided for a particular prudential framework

Draft prudential Rules of the Guarantee Company

Article 1

The Company undertakes to inform in full any lending organization prior to entering into relationship with it. It will attach its statutes, strategic orientations and its latest annual financial report.

It undertakes to comply with all provisions and in particular,

- not to be involved in operations other than direct and indirect guarantees whose purpose is to facilitate access to credit of micro, small and medium-sized enterprises, and if need be financial consultancy to the benefit of businesses requesting for loans or recipients of the guarantee,
- not to collect public savings and to work only on its equity.

Article 2

The Company will ensure the make-up of management bodies that will consist of officers with proven experience and expertise in bank management or knowledge in the management of small businesses.

It will notify its partners of the make-up of its management bodies and the structure of its organization.

Article 3

The Company will be compelled to go into liquidation or suspend its operations with a recovery plan disclosed to all its partners if its functioning were to be conducted under the two following limits:

- prudential capital is less than 3 million, the leverage between outstanding guarantees and prudential capital is more than four times in its
- first 4 years after foundation and six times afterwards.

Prudential capital means:

- capital, reserves, profit brought forward, the profit for the financial year, donations, provisions of a general nature not assigned to particular risks.
- these amounts will be reduced by any allowance for risk in accordance with its policies and on the basis of information transmitted periodically by lending partners.
- Any depreciation of other assets such as investments will be immediately adjusted to market values.

Article 4

The Company is committed under the pact signed by its shareholders not to distribute profits, but to use it to strengthen its capital base.

Article 5

Guarantee operations will be subjected to limits relative to the maximum amounts guaranteed for the same recipient, duration of guarantees, guarantees concentrations in the same region, and in the same sector.

Article 6

The Company will set up counterparty risk, operational risk, and liquidity risk management mechanisms.

- For the counterparty risk, in addition to decision principles ensuring support for only viable projects according to market criteria, the Company will organize its relationships with lending partners in order to monitor commitments and their provisioning. It will ensure the indemnification of loan losses in accordance with the rules of the general contract on collaboration.
- For internal operational risk, the Company will establish and adequate internal audit and reliable mechanisms.

- For liquidity risk, the Company will see that sufficient cash is kept to ensure that payments are made when due; it will diversify investments and modulate them according to their maturities; it will avoid investing in volatile currencies. It will equally avoid investing in shares.

Article 7

The Company will submit its annual account to an auditor approved for bank audit.

In addition the auditor will be charged with checking compliance with prudential regulations independently (without interference). In particular, no management body of the Company will be allowed to make observations on the auditor's report, which shall be sent to partner banks along with the certification report of the annual accounts.

If, during the year, the auditor detected irregularities, he/she should take the initiative to inform every lending partner.

He/she could submit to the Board of Directors every recovery plan, propose reduction of leverage, increase of capital, changes in strategic direction, the suspension of individuals guilty of mis-appropriation of funds. All these measures would be brought to the attention of lending partners.

3.4.5 The Articles of Association

The drafting of the guidelines of the Articles of Association comprise several sensitive points:

Corporate purpose

The corporate purpose needs to be carefully defined.

Any saving funds collecting activity, every credit activity is prohibited. The aim of improving access to credit for micro, small and medium-sized enterprises in collaboration with lenders through the guarantee tool shall be emphasized.

The other possible function is that of financial counseling, guidance or training in corporate finance techniques.

What is meant by:

- Guarantee? (reference to legislative texts in force, its supplementary and complementary aspects to the security of the borrower, payment of the guarantee does not relieve the principal borrower and his co-debtors of their obligations ...)
- SMME?
- access to credit?

It is welcome to highlight the social nature of the business:

- the company is not-for-profit; shareholders do not receive dividend
- a possible liquidation surplus, after paying-off creditors and repayment of shareholders, is donated to another SMMEs promotion agency and not to shareholders.

Organs of the Company

The definition of the powers endowed to the organs of the society is compliant with the legal provisions of a Company form .

The General Assembly, composed of all shareholders, is the supreme organ of the company, empowered to exercise the greatest power: strategy of the company, approval of the reports of the Board of Directors and financial statements, the budget forecasts, the election of the Board members ...

The make-up and powers of the General Assembly are defined by voting rights.

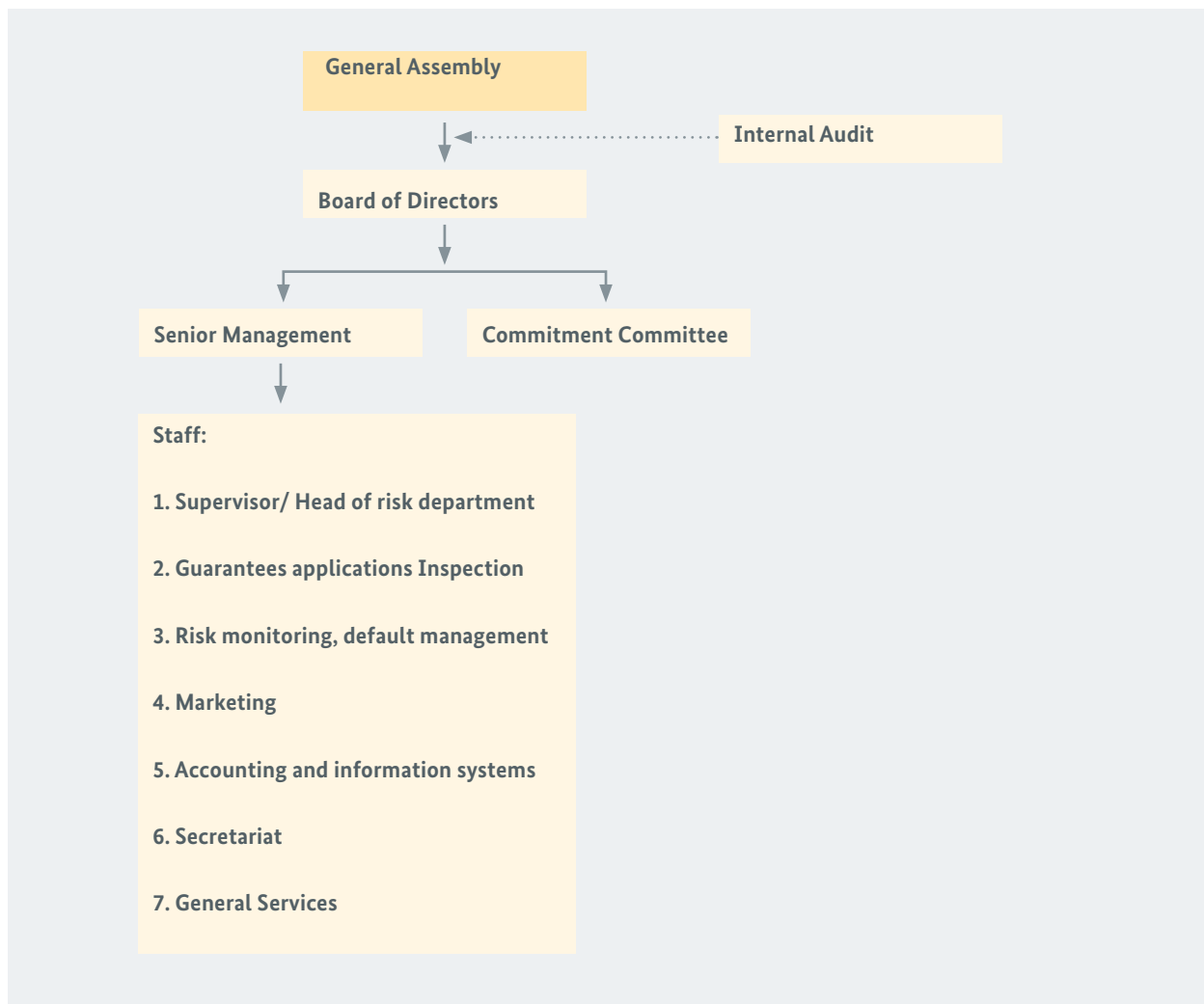
The Board of Directors is the executive organ for the administration and management of the company. It is responsible for:

- proposing the policies to the General Assembly,
- organizing internal supervision and services,
- hiring and dismissing members of the Management,
- establishing periodical accounts and reports for supervisory organs and shareholders,
- signing agreements with partner financial institutions, any counterparty agreements,
- deciding on investments,
- creating regional agencies ...
- taking every measure to preserve the integrity of the Company.

It is highly recommended that the powers of the Board of Directors be delegated to a “Commitment Committee” (also named “Decisions Committee”) to make independent decisions on guarantee applications.

The supervisory function also needs to be planned: the external auditor certifies the truthfulness and accuracy of information contained in the financial statements and other summary documents. His function is mandated by law. His/her report is published along with annual reports.

The structure of management, organisation, and internal control must be effective and appropriate to the purpose and the size of the institution. The Chief Executive Officer may not be President of the Board of Directors.

Example of organization chart:**3.4.6 Hiring key Managers**

Any kind of “parachuting” being rejected, the profile of every function must be defined: good fame and competence, marketing minded; banking experience, particularly credit analysis and risk management; particular sensitivity to the world of micro-enterprises and knowledge of their culture.

3.5 Module 5: Implementation of management policies

General purpose of the module:

In this phase, developers, representatives of the shareholders and key managers review operational issues:

- Drafting the final version of the statutes, procedures, defining policies that are in line with the strategy and compatible with choices made in the business plan.
- Answering the supervisor's questions and other official requests.
- Visiting the government and funding agencies to maximize external.

3.5.1 Policies to submit to the Board of Directors

Limits and thresholds

A sufficient solvency must be ensured in a comprehensive and permanent manner.

- **Maximum amount of outstanding portfolio of guarantees:** for a period of ... years from ...the leverage expressing the maximum extent of the portfolio shall not exceed x times the amount of equity of the Company audited during the last year-end closure. This leverage is broken down into ...times for "wholesale guarantees" and ... times for retail guarantees.
- **Composition of the portfolio:** The Board of Directors must have policies that ensures sufficient diversification of the portfolio: per lender (max ... % of the outstanding portfolio) / sectoral diversification (max ... % of the outstanding portfolio) / start-ups versus existing enterprises / short versus long term commitments
- **Maximum amount of guarantees granted to the same customer or group of clients in one or several operations:** maximum outstanding amount of ... % of equity of the Company audited during the last annual year-end closure
- **Maximum duration of the guarantees:** no retail guarantee shall have a duration exceeding neither the duration of the underlying credit, nor the economic life of the underlying investment asset; the maximum maturity of any transaction is below 5 years for underlying investment credits and 1 year (but renewable by a new deliberation) for overdrafts.
- **Guarantee fees and application fees:** For a period of ... years, the fees are set as follows ...

Powers and corporate governance

- The stability of shareholding needs to be preserved by promulgating rules concerning the admission and resignation of shareholders. This rule is particularly applicable to mutual systems. A shareholders charter can be very useful. A principle of “intuit personae” shareholder could provision that any transfer and cession of shares are prohibited without the consent of the General Assembly.
- Each member of the Board must prove his good fame, his competence and experience in SMMEs business management and / or in financial loan management. It counts ... members.
- Four eyes principle is in vigour.
- The “Commitment Committee” counts ... members.
- It is made up of external and internal experts to decide, in full independence but in conformity with the policies, on the grant or on the conditions for granting the guarantee. Decisions are made ... by consensus?, by majority vote?, unanimously?
- The way that the members are remunerated is not neutral.
- Decision on guarantee applications are taken according to the following principles: composition of the application file, definition of decision criteria, obligation for the partner banker to communicate his own opinion on the case.

- Organ’s members may not participate in any decision involving personal or family interests or leading to potential conflicts of interest.
- Applications, which are the subject of political pressure, will be treated with an a priori negative.
- If the application exceeds the amount of ..., decision will be made by the Board, on the recommendation of the Commitment Committee. Otherwise, the decision powers can be further delegated, leaving the signing of small applications to an expert and the Chairman of Commitments’ Committee.
- The Board of Directors may dismiss members of the Commitment Committee only if the latter violate their duties performed in a professional and honest manner.

Procedures

- At least once a year, an internal audit will check that policies are complied with. Conclusions will be reported to the Board of Directors..
- At least once in a semester, the Board will receive a special report on the functioning of “portfolio” type guarantees.
- Each administrative department will dispose a manual of operations / procedures approved by the Board of Directors.

Cash and investment policy

- The minimum amount that must remain available on demand must cover at least ... months of operating costs + the total amount of individual risk provisions as recorded in the latest balance sheet
- Investments with a term over ... months can only represent ... % of financial assets. They shall have to be distributed among several financial institutions.
- The diversification rule is also applicable according to currencies and types of products so as to reduce investments in volatile products.

Investment policy in fixed assets:

- Investments in equipment, furniture, premises ... shall be decided by ... up to ... (amount). An important facet of the investment is whether the Company will launch its activity by doing paper work or if an E-management system will be developed (acquired) without delay.

Staff hiring policy:

- The criteria for hiring officers and employees shall be defined by ...

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3.5.2 Guarantee application model

Either the guarantor designs a specific and binding application file or he satisfies himself with the dossier prepared by the banker, without any formal model, provided that necessary data are communicated. Generally speaking, entrepreneurs are not familiar with such forms but a more flexible solution entails more work to do by the guarantee officer.

It is very useful to keep the entry date of the file, the date of end of processing by the analyst, the date of decision and the date of the communication of the decision.

Example of application file:

■ The profile of the applicant (sole entrepreneur or company)

Personal data (age, status, domicile)

HISTORY
.....
.....
.....

Competence, skills of the manager:

Number of employees and key functions:

External advisor (accountant): Yes / No

Special aspects

■ Tenancy contract: Yes / No

■ Number of residual years of occupation:

■ Others:

Financial position of the applicant (company or sole entrepreneur)

Professional assets		Professional liabilities	
Available and investments		Accounts payable	
Amounts receivable from clients		Debt to the State	
Stock of goods		■ taxes	
Professional vehicle		■ social security	
Professional equipment		Outstanding bank credits	
Professional buildings		■ microcredit	
Other values		■ funding	
		■ mortgage loans	
TOTAL	X	TOTAL	Y
		Difference = equity	

Existing credits

Amount	Kind (term, bullet, overdraft ...)	Instalment programme (monthly, quarterly, semi-annual)
1.		
2.		

Collateral securities and their market value

1. Real collaterals (mortgage, assets, financial values)
2. Personal guarantee of Mr ...

- Private assets and debts (of the sole entrepreneur and of company manager(s)/ owner(s):

Profitability of the business

	Y - 2	Y - 1	Year
Turnover			
Other business incomes (cite)			
<ul style="list-style-type: none"> ● Gross margin (after change in stocks, purchases) ● Or Added Value 			
% of 2 into 1	%	%	%
<ul style="list-style-type: none"> ● Gross remuneration and fee manager/ owner ● Other gross wages and salaries 			
<ul style="list-style-type: none"> ● renting charges 			
<ul style="list-style-type: none"> ● commercial expenses 			
<ul style="list-style-type: none"> ● ... 			
<ul style="list-style-type: none"> ● Other overheads 			
Exceptional and non recurrent			
EBITDA			
% EBITDA to Turnover	%	%	%
Financial charges			
Financial earnings			
Provisions			
Amortization			
Income taxes			
FINAL RESULT (+ or -)			
Comments:	...		

■ Project, credit, collateral securities offered and guarantee requested

Detailed goal of the project:
...
Technical value of the project:
ex. Launching a business / Family succession / Acquisition of an existing business / Renewal of equipment / New equipment / Inventory / Purchase of commercial building / Construction premises / Extension of premises / Acquisition of a patent / Research / Intangible investments / Payment of past due amounts / Complementary working capital / Cash replenishment after a self-financed investment ...

■ Investment / Financing programme

EXPENSES		FINANCING	
● Purchase real estate property		● Self financing in cash	
● Construction		● Other personal contribution	
● Material and equipment		● Family, friends	
● Inventory		● Credit	
● Working capital		● Leasing	
● Others		● Others	
TOTAL		TOTAL	

■ Credit to be guaranteed

Amount:

Instalments: year 1:

year 2:

year 3:

Interest rate: x % /per annum

Collateral securities offered by the applicant (mortgage, financial assets, professional assets, personal guarantee) of Mr ... (havings and revenues)

Market value of the collateral securities pledged:

■ Business Plan

What is changing in the coming year? // Impact of the investment on the profitability (EBITDA) //

...

Working capital needed by the investment (Covered?)

...

Prediction of future cash flow

Professional assets		Professional liabilities
EBITDA Average 3 years		Existing credit 1: cash drain Y + 1
EBITDA last year		Existing credit 2: cash drain Y +1
EXPECTED EBITDA year + 1		Other loans: cash drain Y +1
(remuneration manager in P&L)	()	New credit <ul style="list-style-type: none"> ● principal ● interest
		<ul style="list-style-type: none"> ● Income taxes adjusted for Y+1
Other (non professional) incomes		<ul style="list-style-type: none"> ● Adjusted remuneration manager
Estimated cash flow Y+1		TOTAL Cash drain Y+1
Comments of our analyst:	...	
Decision taken by the lender:	...	
Decision of the Commitment Committee:	...	

■ BUSINESS SUMMARY

Name and file N°:

DECISION BODY: Commitment Committee-Meeting date: . . .

Credit amount: **Type:**

Rate:

Maturity:

Purpose:

Guarantee %: **Duration:** Years

Annual fee: **% Processing fee:**

Total investment amount: Self-financing in the project: %

Economic value of the project:

Impact of the project on the business:

Dead risk estimation:

Collateral value is estimated at market value / at a forced sale value:

Personal guarantees are given a borrowing value: Yes / No

They seem: good / insignificant

Bank is taking a serious risk / negligible risk

Estimated LGD:

Firm existing since **Years**

Size **Employees /** **Turnover**

The business is well known by the Guarantor: Yes / No

The business is in account in the bank: satisfactorily / unsatisfactorily

Sector: at risk / ...

Activity:

Manager's competence unproved / presumable / proved by

Swot:

1.

2.

Business plan realistic / **questionable** / **unrealistic**

Solvency:

Working capital:

Past due amounts vis-à-vis suppliers (.....), State (.....), Bank (.....)

Special comments on business assets:

EBITDA Y-2 = Y-1 = Y= Trend:

Expected EBITDA from business plan

Estimated cash flow Y+1 + Estimated cash drain Y+1 =



3.5.3 The framework agreement with lenders

“Retail” guarantees

A. Glossary

The terminology used in the contract needs to be clearly specified.

- Guarantee: legal definition and reference to the Code; features (unfunded, direct, irrevocable, legally enforceable partial coverage, absence of solidarity with other private personal guarantors of the borrower, intuit personae character of the commitment ...); nature (financial bearing on a loan or technical on the good performance of a contractual obligation); type (final loss sharing after collateral recovery vs joint and several with the main obligor, bearing on the junior part of the exposure); subrogation (in the rights of the lender; when; how ...), limits (various ceilings of any commitment (value, maturity, sectoral concentration, maximum portion of the loan to receive the protection of the guarantee ...), fees (guarantee fee, processing fee, management fee ...) ...
- Beneficiary: SMMEs (legal definition if any, joint borrowers forming a single entity), eligibility (standard conditions to benefit of the guarantee: registered vs informal, arrears in State debts, business in difficulty, restructuring loan ...); targets (early stage, start-up, business in difficulty, investment, working capital ...) sectors (priority sectors, agriculture) ...
- Credit: types of commercial loans (bullet, term, asset based, overdraft, lease finance, microloan ...); maturity (future flow of payment of principal and interests); interest rate (gross annual % applied + other costs); purpose (repayment of existing loans, business in difficulty, replenishment of working capital, absence of a private goal ...); terms and conditions (reflecting the rights and obligations of both lender and borrowers), credit agreement (specific provisions of a credit line or of a loan/ credit portfolio (nature of borrowers and transactions forming this pool of credit and common management principles), retail portfolio (class of financial assets forming the portfolio per amount, maturity, beneficiary) ...
- Collateral: types (of securities accepted as a pledge for the repayment of a credit obligation + principles of valuation ...); covenant (actions that the borrower pledges to take or to refrain from taking);
- Default: default (irregular situation of a debtor); call (action taken by the creditor in accordance with his internal rules to prosecute a debtor); exposure at default (definition and content of the amount on which the guarantee protection will be calculated); debt collection (friendly or legally enforced procedure to obtain the repayment of a defaulted loan), loss (financial outstanding amount on the account after a debt collection validated by the guarantor) ...
- Others: own funds of the guarantor (means available for unrestricted and immediate use to cover risks of loss), risk provisions (general and specific, reducing the value of the carrying amount of an individual guarantee in the guarantor’s books); leverage; concentration risk; disclosures by the guarantor; reporting by the protected lender.

B. Guarantee application

- Introducing the application (e.g. registered letter with acknowledgement of receipt?, e-mail? ...)
- Content and form of the file (information to be provided on the applicant and his project)
- Principles: sincerity, accuracy, confidentiality, attitude of the guarantor if the same file would be introduced by two lenders ...
- Processing of the application: start of the procedure; processing time; possibility of meeting the applicant with – without- the lender’s assent ... – possibility – or not – to make a conditional agreement ...
- The guarantee agreement (model in attachment)
- Implementation of the agreement: entry in force, validity and ending of the agreement; acceptance by the applicant; information given to the guarantor; payment of the fees and responsibility; date of the first installment of a term loan ...

C. Management of the guarantee

- Lender's obligation vis-à-vis the borrower; equal treatment of credits with and without a guarantee, strict application of the same terms and conditions.
- Disbursement of the credit: in line with the purpose mentioned in the application file; possible sanctions in case of fraud or minor fault; practice of "open books" in case of diligence by the guarantor; obligation to respect conditions to which the guarantor has tied his agreement ...
- Compulsory flow of general information: type and frequency of information supplied to the guarantor, ensuring that both (lender and guarantor) have identical data documenting their statements
- Individual information to the guarantor: list of loans with past due exceeding ... (30, 60, 90 days) compelling him to provision the individual risk; prohibition to modify loan without the consent of the guarantor (changing the purpose, modifying the installment schedule ...)
- Assignment of the borrower's payments in case he has various credit lines in the lender's books (principle of the oldest seniority)
- Insolvency, impairment of a loan: In promising cases loan restructurings should be encouraged (cf. section 2.9.2 above); thereafter principle of autonomy of the lender in accordance with his general terms and conditions agreement; notification to the guarantor (report or only information?); calculation of the carrying amount under the guarantor's liability; obligation to launch a recovery procedure;
- Claim and claim payment by the guarantor (provisional payment before recovery procedure ... debt collection and costs associated, periodical information and evolution of the guarantor's loss; verification by due diligence by the guarantor; calculation of the final loss; possible sanctions framework; payment; subrogation in the lender's rights ...
- Court competent to settle disputes

"Portfolio" guarantees

A. Glossary

see retail, but focus on specificities (amount and composition of the portfolio, validity of the agreement ...)

B. Automatic guarantee commitments

- Validity of the counterpart's decision making: characteristics of the eligible borrower (e.g. sector, ≥ 2 years of existence, timely repayment of 1 ... 2 ... loans granted previously and currently fully reimbursed ...); thresholds of individual deals (max credit exposure of the debtor, maturity of the microloan, beneficiaries, goal of the transaction (e.g. equipment, additional working capital caused by turnover growth ...), types of collaterals pledged to back the risk ...), personal contribution of the applicant (e.g. own funding $\geq 20\%$ of the investment ...) commonly accepted decision criteria (e.g. types of collateral securities, indebtedness ...) ...
- Due diligence (sample)
- Information flows and management of the defaulted credits. Eventually the intervention in losses of the scheme is capped (payment up to % of loss in the portfolio)
- Mutual information: annual financial statement, reports of external auditors ...

3.5.4 Individual guarantee contract

The guarantee contract fits into the framework agreement. It relates to the identification and description of any particular transaction. It specifies:

- The identity of the contracting parties,
- The goal of the project including the expenditures and funding programme
- The underlying loan (amount, maturity, repayment schedule, interest rate and other charges ...)
- The collateral securities given to the lender as a pledge for the repayment of the debt
- Guarantee: rate of protection, maturity, fees and date of their payments, specific conditions imposed by the guarantee committee

The technical guarantee contract is signed by the guarantor and the recipient and sent to the protected counterparty. It clearly refers to the underlying contract and defines accurately the circumstances under which the guarantee can be called and how much shall be unconditionally paid. The contract might stipulate that if the guarantee recipient contested the claim the indemnification would then be paid into an account pending the decision of the court.

3.5.5 Guarantee products

The guarantee as a standard product

The guarantee can be a generic financial product, a simple combination of legal provisions concerning the personal guarantee and risk selection methods (either financial analysis or scoring ...). It addresses all situations without distinction.

The guarantee, a “packaged” product

A market segmentation can shed light on the risks and specific guarantee products can be dedicated to each of the segments: start-ups, investment, working capital, mezzanine finance or agriculture ...

A number of products can then be designed and labeled, so as to be more meaningful to the user:

- the loan cover rate (for example: start-ups with a higher protection than existing companies)
- the fee rate (for example: without public incentive, higher fees to research and innovation investments).
- the composition of the application file (for example: a business plan + market research for a start-up vs annual accounts of the last two years and credit history for an existing business)
- likewise, technical guarantees can even be adapted one by one to the submitted case.

In a few words, products packaging pursues various objectives:

- a market orientation towards better defined groups of customers so as to be more meaningful to them
- adapted pricing that avoids cross-subsidization between purely commercial cost-covering targets and subsidized markets in which more incentive is required
- sharper performance monitoring and better learning process ...

3.5.6 Accounting, management systems and monitoring

Accounting is based on two usual principles:

The accounting plan

Subject to the obligations prescribed by law, the accounting plan pays the greatest attention to the off-balance-sheet records: they register the risk exposures that the Company is committed to pay in case of default of the beneficiaries. The procedure for checking the consistency of the periodic reports provided by the lender must be thoroughly established, implemented and periodically scrutinized by internal auditors.

The flows of information and the quality of the accounting policies must reflect a true and fair view on the leverage, the solvency as they lead to allowance movements to set aside and to reverse amounts that estimate probable loss and to cross-classification of the commitments, in number and values, according to various meaningful criteria as noted in 3.4.4.

The financial analysis of a Guarantee Company emphasizes the quality of its portfolio (carrying amount, granularity, users, thus the leverage, the strategy and the efficiency of the decision making), the risk provisioning policies (various ratios) and the solvency (prudential capital adequacy, thus sustainability in the medium term). Moreover, clear reports delivered to the partnering lenders, the supervisor, authorities strengthen the reliability of the company and the professionalism of its management.

The accounting policies, procedures and valuation rules.

Any other attitude than conservative must be banned.

Valuation rules address primarily provision allowances (general, for general credit risk purpose and individual for identified loss possibilities) and timely settlement of claims.

Prudence applies to investments, liquidity, surveillance of costs.

Procedures must be made in written, implemented and monitored by internal auditing.

3.5.7 Marketing

The importance of this function cannot be overestimated. At the same time, it is not easy to be implemented because the guarantee:

- is a risky financial product which cannot be advertised in the common acceptance of the word,
- it must reach users precisely when they envisage taking a credit,
- it must add value to both lenders and borrowers,
- it cannot represent a promise but only an incentive,

The budget and the promotion strategy depend mainly on the selected distribution channels. In their counseling function, Chambers of Commerce and other SMMEs business associations can fruitfully convey the message.

The best practice is to have the guarantee embedded in financial products that banks propose to their SMMEs clientele. The promotion efforts are also much depending on the channels used by borrowers to have access to the guarantee: either, they could meet the guarantor before going to the lending institution, or they could go the bank counter first.

Files get to the Guarantee Company through lenders' networks

- The most traditional procedure is that the credit applicant visits his/her banker to speak of his/her projects. The banker circulates the file and his decision to the guarantor. At this stage, it is paramount that the credit manager has been duly informed of the existence of the guarantee company and allowed by his hierarchy to use it.
- Two consequences can be drawn. Firstly the highest management level of the lending institutions must have approved the guarantee facility and given instructions to disseminate its message through the operating services and in the branches network. Secondly, credit officers that will have to coordinate the decisions and the whole process must be trained as soon as the take-off of the instrument.
- The guarantee scheme itself must take into account the difficulty of making the tools co-exist. Simple messages, easily accessible procedures, obviousness of the benefits for the bank, stability of the rules, quick decision making, positive and regular communications, explanation of the why yes? why no?, are among the challenges to face for a successful promotion.
- Steering Committees will be helpful as a permanent dialogue place: in the launching phase, both the lenders and the guarantor are in a learning process and they need to exchange their mutual experiences.

Application files arrive directly from the business world

Consulting the guarantor in first instance and then proposing the project and the guarantee approval to the lender is the second avenue giving access to credit.

In this case, promotion efforts are directed to the business world. The challenge is to reach the right person (credit taker) at the right time.

Therefore, every businessman must be aware of the existence and the service expected from the Guarantee Company. Much money could be spent before branding advertisement will drive the behaviors to a new institution!

It is therefore appropriate, beyond persuasive and repeated messages in the business media, to lean on specific channels:

- accountants, tax experts who, as such, should receive a special information (and training?)
- trade associations with which to conclude cooperation agreements, to organize information meetings,
- "check points", or places where entrepreneurs have to go for any kind of formality (license, registrations, tax, subsidies ...)
- website that can deliver a much more accurate information
- the shareholders of the guarantee company.

Conclusions

The finance profession is in a permanent and quick evolution. Thinking about Credit Default Swaps or synthetic securitization, one would have thought that lenders – at least in developed financial economies - disposed of means to reduce their exposure to risk by transferring it to third parties. The recent financial crises did recall the limits of such practices and emphasized the need of serious due diligences, even for sovereign risks. It is to be hoped that new regulations (Basel III etc.) will favour a return of financial institutions to enterprise finance. In particular, SMMEs will remain the backbone of all economic systems. They are vehicles for social and economic development. One would expect that they will remain in the priorities of decision makers whatever the misapprehension of their creditworthiness and the actual obstacles that they are facing to access adequate and not too expensive credits.

Whatever their targets in the lending business, bankers remain confronted with counterparty risk. They shall still have to reckon with legal instruments relating to collateral, registration of property rights and court systems ... Meanwhile, we stress with pleasure the progress made to work out financial data bases (while warning against the replacement of a professional credit analysis with the simple consultation of a file or against delegating a professional credit analysis to a rating agency eager to offer its services). Fortunately techniques of risk analysis have been improved by scoring and rating systems.

As external protectors of SMMEs loan portfolios, as professional interfaces between credit supply and demand, guarantee schemes, however, remain at the heart of a debate: are they useful? expensive? efficient?

Practitioners and academics regularly look into these questions.

For the authors of this manual, it does not make sense to argue about these questions so long as one has not defined what is a “satisfactory” guarantee company: its additionality, its effectiveness, the quality of its intermediation in a given environment that ensures its long term sustainability. Besides, those were questions posed at a World Bank Conference on “Partial Credit Guarantees: principles and practices” in March 2008¹¹⁰.

Behind the project of setting-up a guarantee scheme, the paramount question is “What is the social value for that money?” This question wraps up the paradox of the facility: a financial institution with a social role.

The second conclusion is that setting up a guarantee company requires a good methodology. Architectures are various. We recommend a step by step approach in order, at the end of the day, to create a consensus of all stakeholders and will balance objectives and means in a reasonable way.

Taking as background the most difficult situation, that of developing countries, and refusing the idea of steady flow of subsidies and bailouts of losses, the work perspective is to define **quality standards of Guarantee Companies**

The application of these standards highlights the conditions of success and the reasons for failure.

110 cf. for example http://siteresources.worldbank.org/INTFR/Resources/Honohan_PCG-PrinciplesAndPractice.pdf

Here is an overview of good practices:

Parameter	Suggestion
Legislation Supervision	Supervision is necessary for trust. Consider either the banking rules or a sui generis system
Legislation Articles of association	Review the range of solutions and the possibly mutual character of the Company; Prefer an independent commercial Company or an autonomous department of a Development Bank.
Legislation Taxes	Put forward the non-profit character and obtain exemption of tax of the fees and on risk provisions
Market environment Targeted Businesses	Identify market gaps and focus on objectifs aimed at harmonizing additionality and risk
Market environment Lenders	Do not get involved without their commitment to work faithfully, fairly with a clear framework agreement
Market environment Economic conditions	Avoid: high inflation, abnormal interest rates, social, political instability; absence of legal framework concerning collaterals and securities, very instable court system
Consensus of partners Authorities, lenders and entrepreneurs, donors	Try – even for a small part – to attract lenders and business associations in the Company’s capital. A good project will be tempting for donors. Work with experienced consulting firms.
Organization Non-profit	No distribution of profits, Reserve profit for provisions and for the consolidation of the equity capital
Organization Personnel	Emphasize training. Chase and punish corruption. Give the staff more “entrepreneurial” spirit than “financial” spirit
Solvency Equity	A broad base is required, in line with the business objectives and likely to generate financial returns covering (more or less) operating costs.
Solvency Portfolio, leverage	Care for a mix of diversified and acceptable risks, with a good revolving. Leverage must be modest at the launching (3 fold equity?) and increase gradually with experience and learning process (max 6 or 7-fold equity).
Solvency Guarantee principles	Prefer “loss sharing” guarantee, auxiliary, direct, unconditional, legally enforceable. Never 100 % cover. Modulate according to product (wholesale, retail, portfolio) and to products (start-ups, existing enterprises, technical guarantees ...).
Solvency Fees	Flat-one shot or variable- annual? Ensuring sustainability. Both too low and too high generate undesired effects. Max: 3.4 %?
Solvency Risk sharing	Downstream, never release an entrepreneur by the payment of the guarantor; defaulting entrepreneurs remain responsible. Share the risk reasonably with lender. Upstream, look for counter-guarantee
Management Contracts	General agreement with lender, defined and thorough; multi-annual commitment; steering committee (exchange of good practices)
Management Decision-making	Training of decision-makers ; consider both the qualitative and quantitative elements of the application for a guarantee ; the decision of the guarantor must have an added value different from the lender’s decision.

Management Monitoring procedure	No bureaucracy –the banker transmits standard and periodical information for monitoring the commitment
Management Default management	What is a default? A loss? substantial and timely provisional payment on default; realization of securities by the lender, under guarantor’s control
Management Marketing	In line with the strategy (target groups) and channels of distribution; having various guarantee products will help; budget is important; share planning if possible with lenders
Management Accounting	Standard accounting plan with best attention given to off-balance sheet records and to risk provisions account.
Management Provisioning	General provision + individual provisions (% of the carrying guarantee amount according to seriousness of the borrower’s situation); written policies; internal controlling
Management Fin. Statements disclosure	Timely, complete, accurate, audited; with analysis of objectives and achievements;
Management Internal audit	Necessary; objectivity and independence of the internal auditor; reported

Overview of errors drawn from bad experiences:

Parameter	Observation
Legislation Taxes	Indirect taxes charged on fees; corporate tax levied on risk provisions
Market environment Targeted businesses	Single-sector target market (taxis, hairdressers ...). Sectors with the highest risk (start-ups, top enterprises ...)
Market environment Lenders	To oblige lenders legally to have recourse to the Guarantee Company for all business loans
Market environment Economic conditions	Launch a guarantee scheme whatever the economic environment; euphoric decisions taken at the peak of the upward cycle.
Organization Decision	Allowing permeability to political influence in the decision-making mechanisms. No prudential supervision
Organization Stability	Changing too often basic principles (eligibility, rate of cover, fees, handling and paying defaults ...)
Solvency Equity	Starting with too small capital, postponing funding; Capital formed by contributions in kind and not paid-up in cash.
Solvency Portfolio, leverage	Miscalculation of the leverage, at too high a level; insufficient risk diversification and portfolio granularity (too high risks taken on an individual borrower)
Solvency Design of the guarantee	A system of joint and several guarantee with the lender that lets him the opportunity of fully recovering his own loss on the debtor's assets.
Solvency Fees	Making a financial business, forgetting the "social mission"; bargaining away the guarantee fee
Solvency Provisions	Considering that equity capital is the mattress against risks ; do not set up appropriate loan loss provisions
Management Monitoring	Losing control (no internal control system); policies and limits not reviewed; no portfolio monitoring tools;
Management Defaults	Looking for "venial sins" of the lender to withdraw the guarantee; postponing payment of losses to the end of all legal proceedings against the debtor; various procedures with various lenders

Annexes

Annex 1 – List of abbreviations

ACAD	Arab Centre for Agricultural Development
AECM	Association Européenne du Cautionnement Mutuelle/European Mutual Guarantee Association www.aecm.be
AVHGA	Agrar-Vállalkozási Hitelgarancia Alapítvány (Hungary: the Rural Credit Guarantee Foundation) www.avhga.hu
BMS-SA	Banque Malienne de Solidarité Société Anonyme ; Malian Solidarity Bank
CERSA	Compañía Española de Reafianzamiento s.a.
CGC	Credit Guarantee Corporation (for ex. in China)
CMZRB	Českomoravská záruční a rozvojová banka (Czech-Moravian Guarantee and Development Bank) www.cmzrb.cz
FAO	Food and Agriculture Organization, United Nations www.fao.org
FEI	European Investment Fund www.eif.europa.eu
GARI	Private Investments Guarantee Fund in West Africa (http://fondsgari.org)
GIZ	German International Cooperation (Deutsche Gesellschaft für Internationale Zusammenarbeit, www.giz.de)
GTZ	German Technical Cooperation (Deutsche Gesellschaft für Technische Zusammenarbeit) N.B. GTZ has merged with two other companies to become GIZ
IAPMEI	Instituto de Apoio às Pequenas e Médias Empresas e à Inovação Portuguese SME promotion Institute) www.iapmei.pt
IAS	International Accounting Standard
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standards (N.B.: the IFRS include the IAS)
MFI	Microfinance institution
NFCGC	National Federation of Credit Guarantee Corporations, Japan www.zensinhoren.or.jp
PPP	Private Public Partnership
SIDI	International Solidarity for Development and Investment, www.sidi.fr
SME	Small and medium-sized enterprise(s)
SMME	small (including micro-) and medium-sized enterprise(s)
SOCAMA	Mutual Credit Union for craftsmen in France www.socama.com
SPGM	SPGM Sociedade de Investimento SA, the Portuguese Guarantee system www.spgm.pt
WAMU	West African Monetary Union (in French: UMOA)

Annex 2 – Terminology related to banking and financial guarantees

Assets	Economic resources expressed in their monetary value and recorded in the Balance Sheet such as cash, receivables, inventory of goods, equipment, property and investments.
Agricultural Warrant	Lien on crops that can not be sold so long as the loan is not repaid. One can warranty un-harvested crops or already harvested crops. It is a good and inexpensive guarantee, although complicated to manage. Therefore, it supposes the existence of a specific legislation.
Basel II, Basel III	International agreement between Central Banks on the prudential regulation of financial institutions.
Balance sheet	Statement of the financial position as of the end of a financial year made of three parts: assets, (liabilities and own resources of the owners) and off-balance records.
Bürgschaftsbanken	Guarantee banks, in Germany. www.vdb-info.de
Claim	Situation when a risk has occurred for which a guarantor is entitled to pay to the protected lender. Claim payment is the repayment by a guarantor of losses incurred by a protected lender following the insolvency of a main borrower beneficiary of the guarantee. Claim ratio is the Total claim payments to operational incomes on a year basis.
Credit default swap	Mechanism, similar to insurance, which allows covering financial risks on a case-by-case basis. A creditor acquires, against the payment of a negotiated fee, the right to compensation in case an underlying bond happened to be in default.
Collateral security	A security given by a borrower to a lender as a pledge for the repayment of a loan. Securities comprise financial securities (funded securities), accounts receivable, material assets or mortgages on real estates.
Counter-guarantee	A system of indirect guarantee provided by a third party by which the main guarantor is covered of a part of its credit risk. Counter-guarantees can be granted by authorities, financial institutions or by international institutions.
Covariance	Mathematical expression for the degree of correlation of two series of economic values.
Counter-party risk	Financial risk that is to say the risk of incurring loss due to inability or unwillingness of a debtor to refund his financial obligation in full.

Default	<p>An irregular situation in which the lender does not respect in full his credit obligations. The bank puts the obligation on a non-accrued status and he takes precautions in order to anticipate a loss (individual provisions of the risk).</p> <p>A situation of default is generally defined in the lender's "general terms and conditions":</p> <ul style="list-style-type: none"> ■ either the bank considers that the obligor is unlikely to pay its credit obligations full without a recourse by the bank to actions of realising securities ■ or the obligor is past due by more than ... (90) days on its obligations. ■ the debtor has been placed in bankruptcy or similar protection. <p>The Exposure at Default (EAD) is the credit carrying amount at the moment that the credit is defaulting.</p> <p>The Probability of Default (P.D.) is calculated in number of defaulting deals to the total number of exposures in a portfolio over a one year period.</p>
Off-balance sheet records	<p>Commitments account, not represented by an underlying financial flow likely to give rise in future to a financial flow.</p>
Documentary credit	<p>Used in international trade, this technique is a commitment of a bank to pay a sum against the presentation of a document proving the good execution of a sale</p>
Granularity of a portfolio	<p>The number of individual guarantees in a portfolio. Granularity is a mitigant of the credit risk (in a "granular" portfolio, the general level of risk run by the guarantor is smaller).</p>
Guarantee	<p>Unfunded, personal irrevocable protection of an exposure provided by a third party to cover in full or partially the credit risk of a creditor. Guarantees can be either financial (protection of a financial exposure) or technical (backing a commercial transaction).</p> <p>Types of guarantees are: "final loss sharing" (carrying amount of the debt after collateral recovery is shared between lender and guarantor) or "joint and several with the banker" (junior part of the loan at default is born by both parties in accordance with the contractual guarantee percentage).</p>
Guarantee (portfolio, retail)	<p>A portfolio guarantee is attached to a homogenous pool of credits up to a defined amount. The individual guarantees are granted by the organs of the protected party without any specific approval by the guarantor providing that certain criteria are respected.</p> <p>A retail guarantee is granted directly to a beneficiary entity on a case by case basis after a decision made by the entitled organ of the guarantor</p>
Guarantee schemes	<p>They are financial intermediaries though pursuing a social goal, facilitating the matching of credit supply and demand in order to boost the SMMEs access to finance. Guarantee Schemes are usually ranked in various categories.</p> <ul style="list-style-type: none"> ● Mutual guarantee societies are common initiatives of entrepreneurs or their representative organisations, which commit to grant a collective guarantee to credits issued to their members. They are cooperatives in which beneficiaries own a portion of the capital and take part in the management of the company. The philosophy is based on the mutualisation of responsibility, the decision making by peers, the full compliance with market economy rules. ● Public Guarantee Societies are companies founded by Authorities, mainly or fully state owned, with a liability based on the front line on their financial capacity to take risks with the background of a public protection as a last resort. Notwithstanding, they address private SMEs and are fully managed according to market rules. ● Guarantee programmes are activities exercised by, or in the name of- a Ministry Department as a support service dedicated to SME policy. Sustained directly by the state budget and driven by state strategies. They don't have any status of commercial companies.

Information asymmetry	Frequent situation in credit transactions: the lender base his decision making on information that are not those known by the credit applicant. This leads to an adverse selection of risks
Mortgage	A mortgage loan is a credit secured by a real property. In case of default, the creditor has the right to seize the asset or to obtain from a court the right to sale the asset and recoup the price. A mortgage loan is subjected to a precise and expensive formalism.
Moral hazard	A situation in which the behavior of the borrower can change after the credit transaction has been completed, at the detriment of the lender.
Pledge	A pledged object can be seized at the demand of the creditor beneficiary of the pledge in case of non payment of the loan relating thereto. Pledge often applies to registered vehicles when they can not be sold without certificate of non-pledge. Simple, fast and inexpensive, the value of the pledge lies in the possibility of retrieving the pledged object and maintaining its market value as prescribed over the years.
Provision, allowance	Money set aside in a specific account to cover the general risks associated to his credit activity (general provision for risks) or to reflect the opinion of the lender that an identified borrower could not respect his credit obligations in full and that some loss could be expected (individual provisions)
Securitization	Transformation of a homogeneous portfolio of debts or riks uneasily tradable in bonds able to be negotiated; in the special case of synthetic securitization the original lender (“originator”) transfers only the risks.
SMME	Abbreviation common in many developing country for micro-, small, medium-sized enterprise. In the European Union, a standard definition has been adopted as this category is made up of enterprises which employ fewer than 250 persons, which have a turnover not exceeding 250 million euro and a balance sheet total below 43 million euro. A micro and a small enterprise employ respectively fewer than 10 and 50 persons.
Solvency	Ability to honour his financial engagements; situation of debtor or borrower whose assets are sufficient to cover debts. Basel Accords aim at ensuring the solvency of financial institutions.
Subrogation	Legal substitution of a creditor by another. For example, after compensation of a credit institution through a guarantee mechanism, the latter then becomes holder of the unpaid debt
Systematic risk	Also called: market risk, β risk. Risk that results from instability attributable to a general movement of the market, which characterizes the whole market and cannot be diversified.
Value at risk	Maximum loss under hypothesis of a high probability, but below 100 %. With other words, value at risk is the maximum potential loss under most possible scenarios, to be exceeded only with a very low probability.

Annex 3 – Bibliographie

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Published by
Deutsche Gesellschaft für
Internationale Zusammenarbeit (GIZ) GmbH

Registered offices
Bonn and Eschborn,
Germany

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Edited by
André Douette, Dominique Lesaffre, Roland Siebeke

Design and layout
Barbara Reuter | Oberursel | barbarareuter-grafik@web.de

Photo credits
Title, page 45 © GIZ | pages 9, 31, 37, 54, 58, 71, 94, 115, 122 © KfW

As at
March 2014

GIZ is responsible for the content of this publication.

On behalf of
German Federal Ministry for Economic Cooperation and Development (BMZ);
Economic Policy and Financial Sector Division

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