

Credit guarantee schemes for SMEs – an international review

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In view of the growing interest in microfinance, small enterprises with growth potential, as opposed to microenterprises, may be missing out on donor credit programmes.

Credit guarantee schemes can be seen as filling this gap, since they are aimed at the SME sector, and are intended to help banks learn about lending to SMEs, while being cushioned from the risks involved. This article describes how credit guarantee schemes are being implemented all over the world, and points to some of the problems faced, as well as the advantages of such schemes.

IN THE LAST FEW YEARS there has been a resurgence of interest in Credit Guarantee Schemes (CGSs) for SMEs. Earlier efforts by different developing countries in the 1970s proved less than a resounding success. During the 1980s, economic policy and financial sector reforms were the order of the day and were pressed forward by economists who argued that ultimately the financial markets would open up for small borrowers if the interest rates were right and there was sufficient competition. By the mid-1990s there was little evidence that access to commercial banks had widened significantly for SME borrowers as a result of the reforms.

The increased emphasis on microfinance in the 1990s through programmes such as CGAP – Consultative Group on Alleviation of Poverty, created by the World Bank and several other donors in 1995 – has to be welcomed, but unfortunately there may be a corresponding downside in the abandonment of a number of SME loan programmes developed in the 1960–85 period to provide finance in the range of \$10 000 to \$250 000. The microfinance programmes, however socially laudable, have relatively little economic impact in terms of creating jobs in any significant numbers or in contributing to exports, economic growth, absorbing new technologies or providing support to ancillary industries. The result has been that while in the 1970s and 1980s large sums were given by donors (the World Bank alone approved US\$3 billion in SME support projects in 1973–89), in credits through development and commercial banks, in the 1990s virtually no such credit lines were made available to formal SMEs who need to borrow more. Webster *et al.* (1996) make this point strongly in the review of World Bank support for small business and microenterprises during the period 1991–5. It may be that the renewed interest in CGSs is a move to close this gap.

Most SME specialists would agree that the high administrative costs in relation to loan size which result in low profitability in SME lending is the most serious disincentive to commercial bank lending to these enterprises. Commercial banks also regard lending to SME as a high risk, however, and the inability of such borrowers to offer adequate collateral is also a major deterrent. There has therefore been a renewed interest in

A renewed interest in CGSs may be aimed at helping small, formal sector businesses

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The most serious argument against CGSs is the 'moral hazard' issue

credit guarantees that would compensate the lender for much of the risk, should the borrower default. Not all financial economists would agree that a lack of suitable collateral is the decisive element in discouraging commercial SME lenders. Gudger's article in this issue gives the case of the Caja Social in Colombia, a social-orientated lender to SME which, owing to careful screening of loan applicants, has reduced loan losses to 2 per cent while transaction costs are 14 per cent. These figures suggest that help to reduce transaction costs is the key to increasing lending to SMEs. CGSs can certainly lower administrative costs by reducing the expense of handling collateral.

There are still strong doubts on the rationale for CGSs among those who believe that business development should be left to market forces. The most that one such market economist (Vogel, 1996) would concede was that guarantees 'did less damage than other forms of subsidies, such as those that lower interest rates'. The most serious argument against CGSs, which cannot be totally refuted, is the 'moral hazard' issue, namely that such schemes weaken the will and commitment of the borrowers to repay the loan, when they know that a guarantee fund will reimburse the lending institution. There is also a danger of moral hazard on the part of the lending bank which, it is feared, has less incentive to supervise the loan properly or to pursue vigorously the collection of repayments.

Moral hazard may be less of a real danger, since competent lending banks are zealous of their reputation for high loan-portfolio performance, and will make strenuous efforts to avoid loan defaults. Also, SME borrowers will fear being denied further loans if they fail to repay, even if the loss is covered by a guarantee.

One important objective of a CGS is to provide (under conditions of reduced risk) an opportunity for banks to learn more about SMEs, their problems and their operations, to help improve their handling of SME loan portfolios. The lenders will gradually learn how to lend profitably to SMEs without guarantees. Guarantees may help lenders realize that the perceived higher risk of lending to SMEs may not be so real. Banks have never been keen on CGSs, fearing increased costs and bureaucracy and governments have had, in some cases, to exert pressure and even threats of penalties for non-participation to get banks to take part.

The experience of schemes in operation

A recent global study of credit guarantee schemes carried out in 1995–7 by the consultants, Graham Bannock and Partners, for the UK's Overseas Development Administration, identified 85 countries which claimed in 1996 to have such schemes operating. In several countries there was more than one scheme. Some of the schemes were really only on paper, especially in Africa, but around 70 schemes had some operating record to show.

The study obtained data on operating schemes in 23 developed OECD countries, 6 transition countries of Eastern and Central Europe, 15 in Latin America and the Caribbean, 11 in Asia and 6 in Africa. Some of these schemes are relatively new, such as those in the Czech Republic, Hungary, Poland, Slovenia, Slovakia and Romania, all of which started operating only in 1992–4. On the other hand, some of the CGSs in the OECD developed countries have long histories, such as in Japan (since 1937), USA (1953), Germany (1954), Canada (1961) and Italy (1960). CGSs in the 13 developing countries have now been operating for more than 10 years (see Table 1). Guarantee schemes have also been operating continuously since 1991 in Egypt, Honduras and Trinidad and Tobago.

Table 1. Developing countries where credit guarantee schemes have been operating (start date in brackets)

Chile	(1980)	Colombia	(1981)	India	(1981)
Indonesia	(1971)	Korea	(1974)	Malaysia	(1972)
Pakistan	(1972)	Peru	(1979)	Philippines (IGLF)*	(1952)
Sri Lanka	(1979)	Taiwan	(1974)	Thailand	(1986)
Zimbabwe	(1978)				

*Virtually inactive until revised in 1976.

CGSs have to be adapted and changed as they face real situations and problems in dealing with banks and borrowers. There may also be the need to revise the schemes to conform with changed economic and financial circumstances. Schemes that survive and achieve some success are those that are ready to make changes.

It takes time for co-operative relationships to develop between lenders and guarantors

What has been the experience of these schemes? Firstly, as has already been stated: these schemes have had to adapt many of the features of the original design. There have been changes in eligibility, leverage, risk sharing, fees and claims procedures. A second conclusion from the experience of the longer operating schemes has been that efforts have to be invested in building a co-operative relationship between guarantor and lenders, and this has not proved easy. The fear of moral hazard affecting the lenders is ever present with the guarantors. Lenders for their part have not trusted government-supported CGSs and lack confidence that the guarantees will be paid out quickly and without dispute when a claim is made. The more successful schemes have, after 5 to 10 years, developed the necessary collaborative relationships.

The relatively high rejection rates of claims in the early schemes are mainly due to the guidelines for the respective roles and responsibilities of the lenders and guarantors, poor monitoring by guarantors of the lending institutions, inadequate or imprecise procedures for guarantee approvals and claims, or possibly more than one of these. In the last years, most guarantee schemes have recognized the importance of gaining the confidence of lenders by approving guarantees quickly, and settling claims according to strictly laid down procedures. Usually the requirements for making a claim for a guarantee payout are:

- arrears and non-payment of loans for 90 (or 120) days;
- contacting defaulters and sending out warning notices on time;
- calling in of the total loan after time has lapsed and warnings have been given and ignored;
- the loan being written off in the accounts of the lending institution; and
- the initiation of legal steps to foreclose on any collateral and for the recovery of the loan.

Judicial processes are slow in most developing countries so that the guarantor usually cannot insist on a legal judgement before paying a guarantee, but simply on the *initiation* of legal proceedings.

Another issue is whether the guarantee should apply only to the loan principal or to some of the unpaid interest as well. Some schemes, in Pakistan for instance, operate a guarantee cover for the outstanding loan principal only. However, such schemes are much less attractive to banks, and most CGSs extend the guarantee to a limit of 6 months' interest in the same risk-sharing proportion as the principal.

Risk sharing

Banks that lend money are used to managing risk and regard it as the very essence of successful banking. Many financial economists believe that a major reason for the banks perceiving lending to SME as especially risky is due to the so-called 'asymmetry of information', namely that information on SME borrowers is inadequate and costly to obtain. It is only through a 'learning process' in assessing the risk involved in small clients that banks will acquire the skill to make appropriate lending decisions.

In every guarantee scheme, the lending institution should assume some of the risk

It is advisable, therefore, that in every guarantee scheme the lending institution should assume some of the risk. It might be concluded that loan guarantees should be introduced cautiously, and that no more than 50 per cent of the loan amount should be guaranteed at the start. However, the relatively low level of 50 per cent guarantee means the lending bank has to obtain collateral to cover a significant part of the risk, which could be administratively costly for banks and would inevitably make the scheme less attractive.

An example from Thailand is instructive. The Small Industry Credit Guarantee Fund (SICGF) was launched in 1986, but the response of the bank in taking up the guarantees of 50 per cent of the loans was slow. In 1992, when the Small Industry Credit Guarantee Corporation (SICGC) began operating with a capital of Baht 534m (US\$21.4m), it took over only a guarantee commitment of 407m Baht (US\$16m) after 5 years of SICGF's operation. By March 1996, SICGC's outstanding guarantee commitment was 1274m Baht (approximately US\$51m). After 10 years of operation a leverage of only 2.3 times had been attained.

Although SICGC sets a maximum guarantee amount of Baht 10m (approx. US\$0.4m) for each enterprise, the average guarantee in practice was only between US\$52 400–US\$94 000. The volume of guarantees issued has been significantly lower than was originally anticipated.

The case of Egypt has some different features. The Credit Guarantee Company (CGC) is a joint stock company established in 1989 with a fund of US\$12 million, of which US\$10m was provided in a soft loan by USAID in 1991, at the very low rate of 4 per cent. Although the guarantee coverage is only 50 per cent, the CGC guarantees are attractive to banks in Egypt because the guarantee fund is actually deposited in the participating banks. The scheme in Egypt has an outstanding guarantee amount of US\$85m equivalent in 1995 after 4 years of operation, while the Thai scheme reached only US\$51m equivalent after 10 years (for more details, see the item in Notes and News in this issue on the Egyptian Credit Guarantee Company).

In general, risk sharing of 50 per cent tends to be unattractive to banks since their administrative costs remain high. However, in cases such as Egypt where there are other attractive financial incentives to the participating banks, the low risk-sharing rate may not be a major disincentive. After 10 years of experience of guarantee schemes in Latin America, FUNDES (a Swiss foundation, now moved to Miami) asserts that 'guarantees of less than 50 per cent are of little interest to banks, and 100 per cent invites abuse' (Oehring, 1996).

Most schemes had guarantees of between 60 and 80 per cent of the loan amount

A review of 70 different guarantee schemes both in developed and developing countries found that 17 of them (i.e. around 25 per cent) covered only 50 per cent, while 8 (or 11 per cent) reported that they cover 100 per cent (Levitsky and Doran, 1997). Most of the rest were in the preferred range of 60 to 80 per cent. Most guarantee schemes also set an upper limit for the amount of any single guarantee. Furthermore, although a guarantee scheme may claim to cover *up to* 70 or 80 per cent, in practice it may cover much less.

The prevailing view is that a 100 per cent coverage is subject to greater 'moral hazard' on the part of both the bank and the borrower (if the extent of coverage is known). At present 100 per cent guarantee coverage is mainly confined to countries (e.g. Canada, Japan, Luxembourg, Spain and one scheme in South Africa) where the financial sector and banking system are far more developed, both as regard management and financial soundness. One special case is in Korea, where KOTEC (Korean Technology Guarantee Fund) started in 1989 to encourage SMEs to introduce new technologies. The KOTEC guarantee fund, sourced by the government, which stood at US\$400 million, covers 100 per cent of loans with its guarantees.

Guarantee staff

Credit guarantee schemes need to have staff:

- to review, assess and approve applications for guarantees;
- to receive and review regular reports from participating financial organizations on the numbers of loan applicants and the situation of the portfolio of guaranteed loans;
- to process and review claims for payment of guarantees;
- to follow up on recovery, after guarantees are paid out, of loans that have defaulted (either directly or indirectly);
- to maintain records of guarantees and of claims paid out, to report periodically on the effectiveness of the system and to forecast trends within the schemes;
- to advise or assist borrowers with loan guarantees who are facing difficulties (in some schemes).

The KCGF in Korea at last count (1995) employed 2100 persons and KOTEC, the other scheme in Korea, has 800 employees. In India more than 400 employees (1995) in the DICGC tried to grapple with an ever-increasing volume of claims and were falling behind. These examples show that the need for adequate staff to deal with claims without undue delay and to pursue debt recovery raise the administrative costs of the guarantee organization substantially.

Leverage and bank participation

Like all decisions in designing credit guarantee schemes (such as regarding risk sharing, eligibility, and fees) a sensitive balance must be set for the 'leverage level' of a fund. One of the major arguments in favour of guarantee schemes is that such a fund can provide 'leverage' for a much larger volume of SME lending by banks for a given level of resources. Even though SME lending schemes have in the past, on occasion, proved risky, with a high level of loan defaults, it is usually projected that in the worst of scenarios, with adequate portfolio management, US\$1 million in a guarantee fund could provide coverage for more than US\$5 million in loans, and meet all claims. Experience seems to indicate that with appropriate screening by both the lenders and the guarantors, and effective portfolio management and debt collection, most SME loan portfolios can have a default rate of less than 5 per cent.

A large number of participating banks and a greater volume of guarantees enhance the financial and economic impact of the scheme and its sustainability. Many schemes offer participation to all financial institutions with adequate capitalization and debt-equity ratio, experienced staff,

US\$1 million in guarantees should be adequate to leverage US\$5 million in loans

A large number of participating banks enhance the impact of guarantee schemes

Table 2. Leverage level on some well-established CGSs

Country	CGS started	Activity level ¹ (\$m)	Leverage	Scheme name
Germany	1954	1383 (1994)	26	Burgschaftsbanken
France	1971	2987 (1995)	22	SOFARIS
Italy	1960	1449 (1993)	28	Mutual Guarantee Scheme
India	1981	5453 (1994/5)	11	DK
Korea	1976	7392 (1995)	15	KCGF
Japan	1937	136 918 (1995)	15	CIC & NFCGS
Taiwan	1974	7033 (1994)	10	SMBCGF
Malaysia	1972	742 (1995)	8	CGC Berhad

Source: Annual Report and Graham Bannock and Partners Survey 1995–7

1. Activity level is the value of new guarantee commitment taken on in the year.

clear procedures and an acceptable performance level of SME loan portfolio. On the other hand, a large number of participating banks, each with only a very small guaranteed SME loan portfolio, makes it difficult and costly for the guarantor to monitor the scheme. It is also unlikely that banks with only a small number of SME borrowers and guarantees would invest sufficiently in staff. The guarantee scheme should therefore include the major banks that together have assets and clients covering more than 50 per cent of the banking sector and possibly a few others that have the right type of eligible clientele and satisfactory loan portfolio performance.

Higher leverage levels are reached in industrialized European and Asian countries with well-endowed, large and long-established schemes and sound banking systems, as shown in Table 2.

In Table 2, leverage is calculated as the ratio of 'total outstanding guarantees' to size of guarantee fund. It is difficult to calculate, since it fluctuates with the outstanding guarantee level and the fund amount. The latter is affected by guarantee claims paid and new contributions into the fund.

In Colombia, the leverage level of the FNG (Fondo Nacional de Garantías) fluctuated from 3.74 in 1992 down to 1.40 in 1995, primarily because of large re-capitalization of the fund in 1994–95. Apart from the countries in the above table (Korea, India, Taiwan, Malaysia) most CGSs in developing countries have lower leverage levels: from less than 1.0 (Trinidad) to around 5.0 (Ecuador). In some cases, the failure to reach a higher level is not due to conservatism on the part of the lending or guarantee organizations, but a result of weaker than anticipated demand by SME borrowers and a reluctance of financial lenders to make use of the schemes. There is also, in many cases, a lack of information for potential users on the existence of the facility and how it operates. A conservative approach is sometimes imposed by the CGS board, as in Thailand, where the board limits the SICGC to a leverage of 3 to 1.

In recent years some donors have provided guarantee funds for single banks. The Loan Portfolio Scheme of USAID is based on contracts with specific banks for 'blanket' 50 per cent guarantee coverage on SME loans. ODA initiated such a scheme in 1994 with Barclays Bank in Kenya. The scheme has faced problems, both in the bank's limited outreach (even though it is one of the major banks in the country) and the lack of enthusiasm of some branch managers. It had only issued 37 guarantees by the end of 1995 for an amount of Ksh 20m (US\$360 000 approximately). In late 1996, the ODA also provided £500 000 for a CGS with the Commercial Bank of Zimbabwe.

CGSs in many developing countries have relatively low leverage levels

Leverage growth takes time, as confidence has to develop between the guarantor and lenders

Leverage growth takes time as confidence has to develop between guarantor, lenders and the borrowers involved with the CGS. There is usually over-optimism on estimates of 'take-up' of the scheme. A leverage level of five times the fund after 5 years of operation can be considered acceptable usage, and a leverage of 10 after 7 to 10 years of operation may be as high as one should reasonably aspire to and only when claims are not too high. A leverage of less than 3.0 after 5 or more years of operation raises serious questions about the rationale for the scheme. However, too much pressure to extend guarantee volumes to higher levels too quickly, or to increase the risk coverage – say from 70 to 80 per cent – simply to attract more bank use of the scheme, has the danger of pushing participating banks towards more risky loans.

Guarantee claims and debt recovery

The procedures for when and how claims on the guarantee can be made are often imprecise

Early guarantee schemes in developing countries failed to put in place suitable procedures or adequate staff for handling claims for payment of the guarantee. The procedures for when and how such claims could be made tended to be imprecise. Such phrases as 'the guarantee shall ensure that the lender has diligently taken all required steps to recover the loan', were used. This type of language can lead to disputes and delays in the early years of a scheme, undermining the lender's trust in the reliability of the guarantee agreement.

The history of the CGS in Malaysia is illustrative. There have really been 4 different credit guarantee programmes, General Guarantee Schemes (1972–81), Special Loan Scheme (1981–8), Principal Guarantee Scheme (PGS) (1989–94) and the New Principal Guarantee Scheme since 1994. The PGS expanded the limits of eligibility, and raised the guaranteed portion of the loan from 60 to 70 per cent. Lending interest rates and margins were also changed and the guarantee premium lowered. Notwithstanding these changes, all to make the schemes more attractive to the banks, CGC loans accounted for only 6 per cent of the banking system's lending to small firms in 1993, and this despite the Central Bank's (Bank Negara) imposing quotas on the CGC SME lending target to be achieved by each financial institution (Boocock and Shariff, 1996).

Over the period 1986–93 the CGC processed 3563 claims for guarantees totalling payments of RM36.4m (US\$5.1m), but only 1505, totalling RM9.3m (US\$3.9m) were paid out. The remaining 2058 claims (RM27.1m) were either rejected or withdrawn by the banks. The screening of loan and guarantee applicants were improved by the PGS in the early 1990s, claims procedures were set out in greater detail and made more efficient, and by 1995 the new PGS had a much greater volume of outstanding guarantees.

By 1995 the loss rate was down to 0.21 per cent. This low loss figure may give a distorted view due to the considerable increase in 1994–95 in the volume of guarantees. The high level of claim rejected in the earlier CGC, suggests technical reasons were being used to refuse payment of guarantees (Boocock and Shariff, 1996).

In India, guarantee schemes have been in operation since 1981, including one for loans to small-scale industries (SSI, defined as having assets less than Rs6m or Rs7.5m [for exporters and subcontracting industries] i.e. US\$ 180 000–220 000 respectively). Although claims increased from 45 000 in 1987 to 190 000 in 1994–5, the actual gross paid-out claims rate was 5.8 per cent. As 6.8 per cent of this amount was later recovered, the net loss rate was 5.4 per cent. Significantly, 23 per cent of claims

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in the SSI scheme were not paid out — they were either rejected or withdrawn by the claimant bank.

The Indian Deposit Insurance and Credit Guarantee Corporation (DICGC), which combines these unrelated loss indemnification activities, is finding it increasingly difficult to keep up with the processing of the volume of claims for both the credit insurance schemes, despite employing a large staff of over 400 in the Head Office. By early 1996, the DICGC began to fall behind in the handling of claims. DICGC has already imposed more stringent conditions before a claim could be made, such as a three-year period between loan disbursement and the writing off of loans in lenders' accounts (banking procedures in India usually require a loan to be classified as 'doubtful' for two years before it can be written off). DICGC has more recently announced its intention to tighten conditions further, but has encountered opposition from the banks.

Some other schemes have suffered high claim rates at times. The Korean Credit Guarantee Fund (KCGF) was set up by a special law in 1976 with a government contribution to the fund of the equivalent of US\$707m by 1994. The law provided for the KCGF to receive the proceeds of a levy (0.17 per cent of loan portfolios) imposed on all banks which, by the end of 1994, provided US\$1979m. During 1995, the government contributed a further US\$374m, while the levy on banks was US\$324m in that year. However, up to and including 1995, KCGF paid out a total of US\$ 2675m on guarantee claims. In 1995, 7508 guarantee claims were paid out for US\$1060m, leaving US\$709m in the guarantee fund. The number of guarantees outstanding with KCGF at the end of 1995 was 126 952, for an amount of US\$10 573m, 15 times the guarantee fund.

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The above figures give some idea of the high level of activity of the KCGF. It is estimated that the KCGF is used by over 13 per cent of the SMEs in the country who borrow from financial institutions. KCGF is not merely a guarantee organization, it is also the largest credit rating institution in Korea. However, KCGF's loss rates have been relatively high, recording in 1994 a 6.8 per cent gross rate of 'subrogation' (meaning that the guarantee has been paid out and the debt taken over by the guarantee organization for collection).

Loan recovery after subrogation

KOTEC (the Korean Technology Guarantee Fund) faced a significant rise in subrogations between 1991 and 1992; 64 497 in 1991, rising to 230 018 in 1992 due to a severe and prolonged economic slowdown in the country. The 1992 figure is a gross claim rate of 18 per cent (against 4.7 per cent in 1991). As KOTEC was created to stimulate new technology in smaller firms, this loss may still be considered lower than would be the case if grants or subsidies were made available.

These figures indicate *gross* claims. The *net* rates are lower since great efforts are made in Korea (as in Japan) to recover loan debts *after* guarantees are paid out. In 1991, in the case of KOTEC, 6.65 per cent of the amount in subrogation was recovered, and in 1992, 7.76 per cent. In the case of KCGF, the subrogation rate for 1994 was 6.8 per cent gross, but 22.7 per cent of the guarantees paid out were subsequently recovered, reducing the net rate to 5.4 per cent.

ASKRINDO, Indonesia's state-owned credit insurance company founded in 1973, recorded a 50.34 per cent loss claims pay-out rate by 1994 of which 7.7 per cent was later recovered (Hatekayama, 1997). The scheme and the company have since been reorganized.

Loan recovery after payout by the guarantor is pushed vigorously in Japan and Korea

Loan recovery after the subrogation of loans is pushed vigorously in some Asian countries, and particularly in Japan. According to the 1994 figures, 1.4 per cent of the very large guaranteed amount in Japan was subrogated, but 53.8 per cent of this amount was later recovered. This is more than in European schemes where loan recovery has generally been left to the lender.

The FNG (Fondo Nacional de Garantia) in Colombia, one of the oldest guarantee funds in Latin America (established in 1982), provides an informative example. The gross claims rates have fluctuated from a high of 981 guarantees paid out in 1991 (18.2 per cent of the 5053 guarantees issued that year) to a low of 134 (7.9 per cent) out of 1705 issued in 1993. Over the whole history of the FNG (1982–95), 3899 guarantees were paid out, amounting to 9.0 per cent of the 43 200 issued altogether. However, 1109 of the guarantees paid out or 28.4 per cent were recovered i.e. 2.5 per cent of the sum paid, and leaving a net claims rate of 6.5 per cent.

In both Japan and most Western European schemes (especially mutual guarantee schemes in France, Italy and Spain), there exists a reinsurance or second-tier reguarantee mechanism which helps to generate confidence among the lenders that there will be sufficient resources for the guarantee commitments to be met. This means that the 'reserves' to be maintained by the fund can be lower.

Best practice indicates a claim rate of 2–3 per cent

Comparing levels on guarantee claims (or loss) rates is difficult. Where the volume of guarantees is rising, the claims or loss rate will tend to be low since most borrowers do not default in the first year of repayment after a loan is disbursed. The rate of claims on guarantees against the amount of guarantees outstanding can really only be assessed after five or more years of continuous operation. Best practice seems to indicate a claim rate in the order of 2–3 per cent. Although there might be exceptions, a zero claim rate would tend to indicate that there had been an overcautious approach to the approval of guarantees.

A guarantee claim level rising above 5 per cent of the total amount guaranteed should give a signal that there is a need to take some remedial action.

Claim rates are influenced both by the economic situation in the country and the competence of the financial and banking sector. In Thailand, for instance, claims rose in 1994 and 1995 as the economic situation changed.

Most schemes make a charge for the guarantee

Guarantee fees

Apart from a few exceptions, such as Pakistan, most schemes make some charge for giving a guarantee. These are in the form of fees to the bank, but in practice the lender passes them on fully to the borrower.

Fees generally vary, both as regards the percentage and the manner applied. Some levy the percentage of the total loan and some only on the guaranteed portion. Furthermore, there are schemes which impose a registration fee as payment for the processing of a guarantee application and after the issue of the guarantee an annual fee on the amount covered.

The registration (typically 0.25–1 per cent of the loan) and annual fees (0.5–2 per cent of the guarantee amount) for various schemes in Europe in 1994 were rather lower than in developing countries. In developing countries a registration fee of 1 per cent on the loan amount (wholly or partly unrefundable) and an annual fee of around 2 per cent on the guarantee (paid in advance) is considered to be an acceptable level. Raising fees too high, to 4 per cent or higher, has in some cases deterred borrowers and lenders from using the scheme. Of course, the fee level has to be related to interest rates. In Japan the 1 per cent guarantee fund is

regarded as high since the prime rate of Japan's commercial banks hit an all-time low in 1995 of 2.1 per cent. On the other hand, when interest rates are 15–20 per cent, as in Colombia, the FNG fees of 2–4 per cent are not regarded as a major deterrent to requesting a guarantee.

The costs of operating guarantee schemes

All guarantee schemes contain some element of subsidy

All guarantee schemes contain some element of subsidy: either in the contribution (public, private or external donor) to setting up the guarantee fund, or in some cases in the form of a rent to cover some of the costs of administration of the programme. The subsidy may also be in the form of cheaper donor funds available for credit lines to SME (on which guarantees are offered).

Hatakeyama (1996) gives comparative figures for the year 1994 on the operational costs of the CGS in a few East Asian countries which were incurred for a loan of US\$1000 equivalent (Table 3).

She also gives estimates of the cost to the public funds of operating the CGS in 1994. Most of these public funds were in the form of central or local financial support (Japan), or as additional paid-in capital to the guarantee fund to cover potential erosion and to bolster funds so that investment income can rise to help cover operating expenses.

Some more ideas of the costs of setting up and operating credit guarantee schemes are given in the examples of Hungary, Romania and Trinidad and Tobago.

In Hungary, the Credit Guarantee Corporation was established in 1992, and by 1995 there were 866 guarantees outstanding for an amount of US\$92.43m equivalent. In 1994, virtually the first full year of operation, the CGC approved 186 guarantees for a sum of HUF 3.08bn (US\$ 21.6m), with an average coverage of 54 per cent. The Hungarian CGS guarantees up to 80 per cent of a loan. Staff costs for 1994 were HUF 120m (US\$0.85m) and other administrative expenses added another HUF 57m (US\$0.36m) making total administrative costs of US\$1.25m, a rather high figure considering only 186 guarantees were issued in 1994.

The Romanian Loan Guarantee Fund (RLGF) was set up in 1991 with a capitalization of US\$9.2m equivalent by 1995. RLGF can cover up to 70 per cent of loans, but the actual average guarantee in 1995 was 34.1 per cent, with a 1 per cent registration fee retained by the guarantor even if rejected, and an annual fee of 3 per cent of the loan guarantee paid in advance. By early 1996 there were 37 guarantees issued with general administrative expenses for 1995 of ROL 495m (US\$0.18m approx.). The RLGF management is criticized by some banks as being over cautious, and more concerned to declare profits, which depended in 1995 primarily on interest income (ROL3.6bn, or US\$1.3m), rather than fees which only amounted to US\$0.136m. The RLGF has a mandate to show a profit, pay taxes, safeguard its capital and pay dividends to its shareholders, who include an agency of the government and four

The Romanian Loan Guarantee Fund is very profit oriented and is criticized for being over cautious

Table 3. A comparison of costs of operating credit guarantee schemes in 1994

	<i>Japan</i>	<i>Korea (KCGF)</i>	<i>Indonesia (Askrindo)</i>	<i>Malaysia</i>
Operational costs to the CGS of a US\$1000 loan	US\$28.27	\$71.23	\$75.30	–
Costs to the public funds of operating the CGS	US\$68 million	US\$3 million	US\$20 million	US\$0.2 million

commercial and development banks. The policy of RLGF appears very profit orientated, with a reluctance to issue more in guarantees and so reduce investment income.

In Trinidad and Tobago, the Small Business Development Corporation (SBDC) has run a credit guarantee scheme since 1990 with a guarantee fund of TT\$30m (US\$5.2m), and 1855 guarantees were issued between July 1990 and February 1995 for a total of TT\$28.4m (US\$4.93m) (Allahar and Brown, 1995). Of these, 164 were never taken up and 234 (12.6 per cent of guarantees issued) were paid out in claims for an amount of TT\$2.6 or 9.2 per cent of the guarantees approved.

In 1994, the operational expenses of the Trinidad CGS were TT\$1.3m (about US\$0.226m), while at the end of 1994, 993 guarantees outstanding were worth TT\$16.6m (US\$2.9m). This means that the *total cost* of operating the scheme was 13.8 per cent + 8 per cent = 21.8 per cent of guarantees outstanding.

These figures indicate the substantial costs of running a guarantee scheme in a small country with a reasonably sound banking system. After five years of operation, SBDC is considering introducing a portfolio guarantee system at least for the two major participating banks (who account for 62 per cent of all guarantees) to lower the costs of operating the scheme.

Additionality

If the same amount of lending to SMEs would have taken place without the guarantees, then one of the main justifications is disproved

The term 'additionality' refers to the 'additional' loans made possible due to the guarantee against loss provided to the lender. Much has been written about the difficulty of measurement of 'additionality' (Meyer, 1996). If there are few such 'additional loans', and the same amount of lending to SME would have taken place without the provision of guarantees, then one of the main justifications for a guarantee fund would have been disproved.

A few schemes have actually tried to find out if there has really been 'additionality' as a result of the guarantees. Others have tried to ensure additionality by authorizing guarantees only for first-time borrowers from each bank, but this has proved restrictive. Some guarantors in developed countries such as Canada and UK have tried to insist that borrowers show evidence they have been rejected for a loan by banks before they can apply for a guarantee, but this is hardly conclusive in most cases.

FUNDES, the Swiss-based international guarantor for SME working in Latin America since 1986, maintains that 90 per cent of borrowers helped by the organization would not have been able to get the credit, and certainly not on the same terms, without the guarantees arranged for them (Oehring, 1996). This was the conclusion after a review of guarantees granted in 1993 and 1994 in the six countries: Panama, Costa Rica, Guatemala, Bolivia, Chile and Colombia.

A fuller study was made of a limited sample of 32 recipients of guarantees in Malaysia over the summer of 1994 to determine the level of financial and economic additionality involved (Boocock and Shariff, 1996). In total, the 32 firms received RM2.28m (about US\$0.4m). Analysing the replies of borrowers and banks it was concluded that 63 per cent of the guaranteed loans were additional. (This 63 per cent refers to *bank* finance only. The earlier replies of borrowers included alternative non-bank sources of finance, as did the UK studies.)

In the UK, two studies showed 48 and 68 per cent additionality respectively (NERA, 1990 and Pieda, 1992). In the case of economic additionality, 27 out of the sample of 32 (85 per cent) in Malaysia thought the

guaranteed loan had helped their businesses, and that there had been an increase in profits and sales and 21 (60 per cent) saw limited increase in employment (Boocock and Shariff, 1996).

In Malaysia, mandated lending for indigenous SMEs is imposed on banks, in that they are required to lend up to a targeted quota of guaranteed loans to indigenous SMEs. Of course, this distorts the problem of 'additionality', as this may have caused banks to approve guaranteed loans for high risk mainly to meet this requirement. (The same situation exists in Pakistan, India and Indonesia).

Guarantees can sometimes improve the conditions of the loan, such as longer repayment

Meyer (1996) has commented that offers of guarantees can sometimes improve the conditions for the loan such as longer repayment, and a less stringent collateral demand for a larger loan. This can also be considered a form of additionality.

Hatakeyama (1996) reports that in Japan 52.9 per cent of all those classified as SMEs had received at some time a credit guarantee, making such loans very widespread. Nevertheless, the same paper also states only 7.5 per cent of all lending to SMEs in 1994 used credit guarantees, which shows there are also a number of other options for SMEs to obtain finance. Riding (1996) estimated, after examining the cumulative distributions of size of annual sales and number of employees of bank borrowers who use the Small Business Loan Act Guarantee Scheme in Canada, compared to the distributions of non SBLA borrowers, that 'approximately one-quarter to one-third of SBLA borrowers are unquestionably additional'.

Additionality of at least 60 per cent should be the minimum acceptable

One may conclude from the limited data available that some additionality, usually at least 30–35 per cent, exists in all guarantee schemes that are properly designed and implemented, but economic additionality (strengthening businesses, increasing profit and sales, employment, exports, and so on) may be considered by most designers of guarantees as a more important objective than financial additionality. Additionality of at least 60 per cent should be the minimum acceptable for justifying a CGS. Sample studies should be carried out by CGSs every two to three years to verify the degree of additionality achieved in lending to SMEs.

Subsidies are justified because strengthening the SME sector is a social and economic good

Sustainability

Some financial economists believe that guarantee schemes should be designed and implemented in a way that does not require continuous subsidies from the government or from donors. As against this, in several countries, notably in East Asia and Europe, the prevailing view is that the strengthening of the SME sector is a social and economic imperative and therefore subsidies are justified, and that guarantee schemes may be one of the most effective and least distortionary ways of providing assistance. There is little dispute in Japan, Korea, Indonesia and Malaysia that subsidies are justified, especially in Indonesia and Malaysia, where there is also the socio-political objective of increasing indigenous participation in the economy.

In Japan in 1990, the government provided subsidies to the elaborate guarantee scheme throughout the country mostly through the reinsurance corporation SBIC (Small Business Insurance Corporation) to the tune of US\$50m, but the NFCGC (National Federation of Credit Guarantee Corporation) of Japan prides itself on the effectiveness of the CGC in ensuring a loss rate of only 1.4 per cent, of which 58.3 per cent was later recovered. However, the Japan guarantee system has faced problems in recent years as the value of defaults increased with the prolonged recession, so that payment under guarantee reached an all-time high in 1994 of 3.85 billion yen a year (US\$38.2m).

In contrast, the Indonesian Credit Insurance System (ASKRINDO) was always regarded as a necessary guarantee subsidy and was considered as government support to strengthen the 'pri-bumi' (indigenous sector). As noted earlier, US\$20 million of government funds were used to bolster ASKRINDO in 1994.

Recent studies (Bannock and Partners, 1995) reported that the guarantee schemes in Germany, Italy and the UK all depended on significant budgetary support from the government. The German scheme required relatively small government support but the UK and Italy lost around 14 per cent of each loan, made up by government funding. There are also examples from Philippines, Colombia and Nepal where operating expenses were far greater than income from guarantee fees.

On the other hand, Riding, reviewing Canada's experience, believes 'the parameters of a loan guarantee scheme can be manipulated so that subsidies are *not* required' and he gives some relevant figures on the Canadian SBLA guarantee scheme: 4.5 to 5 per cent default as offset by the fee of 2 per cent of the loan amount. The C\$3 million annual operating budget (1995) for support for the SBLA is covered almost completely by the recoveries from borrowers in default. He concludes therefore that the SBLA is currently operating with no cost to the government. The fees since 1995 are sufficient to promote additionality without incurring adverse selection.

In general, the level of 1 per cent opening fee on loan amount and a 2 per cent annual percentage on the guaranteed portion should cover all the administrative costs provided the volume of guarantees is large enough.

Apart from guarantee fees, the main income is the interest earned on investing the fund. There is always the danger that if there is too much stress on 'making a profit' (as in Romania) this may create a tendency in the guarantee organization to be slow in issuing guarantees so as not to reduce income from the investment of the fund. The fund is usually invested in government securities and bonds but in some cases the funds are placed in deposits in commercial banks as in Japan. This is not so much to maximize returns as to make the money available for bank lending. In Thailand and Hungary there is a 'back-up' guarantee of 70 per cent by the government.

In some developing countries, donors have contributed to guarantee funds: USAID, ODA, EU, GTZ have provided finance particularly in Africa, but also in Asia, Latin America and in Eastern Europe. Where donors provide matching funds, to those from domestic, private and public sources it can be a satisfactory arrangement. A guarantee fund made up *only* from a donor grant may increase 'moral hazard'.

A guarantee fund made up *only* from a donor grant may increase 'moral hazard'

Conclusions

There is no international consensus that credit guarantee schemes are an effective or economic way of widening access to formal bank credits for SMEs. It is clear that credit guarantees can only work when there are competent, financially sound banks, with adequate staff that can effectively manage SME loan portfolios to acceptable levels of performance. It should be possible then to achieve a reasonable level of leverage, i.e. a loan portfolio of 5 to 10 times the amount in the guarantee fund within a period approaching 10 years of operation of the CGS.

Meyer (1996) believes that 'in spite of the heightened interest . . . in guarantees, many studies . . . suggest questionable impact'. He sees the minimum criteria to be evaluated as 'additionality and sustainability'. If there is no additionality or very little 'there is little reason for a guarantee'. If there

is no sustainability 'there is no assurance that even if they maintain a good repayment record there will be . . . guarantees available in the future'.

While recognizing that credit guarantees cannot respond to all needs of SMEs, most developed and more advanced developing countries believe that CGSs are probably the *most economic* use of funds in financial support for SMEs, provided that an acceptable level of leverage and additionality is attained. Guarantees operate best in a liberalized financial sector where banks compete for clients.

The guarantee organization may, in the course of time, transfer increasing amounts of decision-making to the accredited financial institutions after they have achieved and maintained acceptable levels in their loan portfolio performance. Every CGS should be subject to a limited measure of regulation to ensure that, at all times, it conducts itself in a manner to enable it to meet its commitments.

Credit guarantee schemes are long-term mechanisms of support for SME and must be given adequate resources to carry out their objectives and time to build up the trust of the financial institutions.

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