CREDIT GUARANTEE SYSTEMS FOR AGRICULTURE AND RURAL ENTERPRISE DEVELOPMENT

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Preface

Guarantee funds have been used over the years in many countries, forms and contexts as a way to increase the flow of funds into targeted sectors and groups. Various types of guarantee systems and scheme are used to make lending more attractive by sharing or absorbing the risks associated with lending to the targeted sector or type of enterprise. Such systems can also increase the amount of loan funds available to an enterprise beyond its own collateral limits, because the guarantee is a form of loan collateral. The guarantee manager can assume the additional role of loan assessor and monitor, which can improve the quality of the loans made.

However, guarantee funds have a cost, which is paid through the fees charged and/or subsidized by the government or a donor. Questions arise regarding the cost versus the benefits when a subsidy is needed. What is the value added of guarantee funds in reducing interest rates or the risks to lending, and how much do the funds influence lenders decision-making regarding whether or not to lend?

Guarantee funds have more frequently been used for small enterprise loans in diverse sectors, but they are now quite common in agriculture and agribusiness. There is renewed interest in using them to increase investment into the sector and to ensure that investment is directed towards target groups and agro-industries that are deemed too risky for adequate financing without such risk-sharing incentives. This document takes a fresh and unbiased look at the application and results of guarantee funds for agricultural and rural enterprise development. Through analysis of guarantee funds that have been operational for a long time, the document aims to inform development agencies and policy-makers on current practices and experiences, so that they can apply this information to their decision-making regarding whether or not and/or how best to promote guarantee mechanisms that are effective and sustainable.

This document builds upon four major case studies of guarantee funds and 12 other analyses of such funds. A detailed description of the four cases will also be published and available at http://www.fao.org/ag/ags

Executive summary

Partial credit guarantees are a comparatively new instrument in agricultural development finance. Following the introduction of credit guarantee systems (CGS) in Japan in 1937, their use spread first throughout Europe and the Americas in the 1950s, and then to Africa, Asia and Oceania in the 1960s and 1970s. A recent count found 2 250 CGS in almost 100 countries. Newer forms of CGS cover not only individual end borrowers, but also parts of the entire loan portfolio, with exposures in areas of interest to policy-makers and development banking practitioners. For small and dispersed rural and microfinance institutions, the guarantee cover may be applied to the entire loan portfolio. Other new forms of guarantees include bond guarantees and portable guarantees, which are discussed in detail in this study. Whether the guarantee covers the institution or the loan of the end borrower can make a big difference to the public policy appeal and acceptance of these schemes.

The most frequently raised argument against CGS in the past was that they could not sustain themselves out of guarantee fees and/or investment returns on the underlying capital. CGS are not alone in being vulnerable to failure without subsidy inflows. Even full service banks with individual microenterprise lending technology, and conventional microfinance non-governmental organizations – which are the two most frequently quoted new types of microfinance institution – do not claim to be subsidy-free. These institutions are subsidized for their establishment and initial capitalization. The subsidies are phased out as the institutions grow and secure access to commercial sources of funds.

Large challenges also emanate from the fact that most CGS worldwide are capitalized out of public funds and managed by staff with pay and employment histories that are typical of public sector employees. Political interference and the inability of CGS managers to minimize this interference have brought an end to many CGS, particularly those operating in developing economies.

The general lack of transparency in the presentation of financial results of most CGS is a further weakness that contributes to their fragility and potential misuse by forces other than those with commercial and development objectives. The detailed case study of the large Indian CGS illustrates this point.

This study provides a review of agricultural CGS worldwide. The focus is on testing a few key study hypotheses and examining concrete case examples and empirical field realities. Four case examples from four continents are analysed in detail and referenced throughout the study: the Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) in India, the Agricultural Credit Guarantee Scheme Fund (ACGSF) in Nigeria (the oldest CGS in sub-Saharan Africa), the Rural Development Foundation (RDF) in Estonia, and the large and well-established *Fideicomisos Instituidos en Relación con la Agricultura* (FIRA – Trust Funds for Rural Development) set of guarantee funds in Mexico.

Using these and 11 shorter case examples of CGS, which are presented in the form of comparable term sheets in the annexes, the study highlights and analyses the complex nature of many CGS and their sometimes positive, but often also inconclusive or negative, long-term track record. Study results indicate ingredients for good practice in setting up and managing individual or portfolio guarantees. They also identify potential areas of underperformance and eventual failure. The study argues that CGS are neither the panacea nor the preferred option for development finance that bankers tend to portray them as; however, neither are they doomed to fail, as their critics would suggest when referring to the disadvantages of the public funding and start-up subsidies that are usually involved in setting up CGS. Instead, their strengths and weaknesses have to be analysed case by case.

As the FAO Global Expert Roundtable on Agricultural Guarantee Funds has shown, there are positive precedents for operating with different types of guarantee. Success is facilitated by a generally healthy banking sector with generally low levels of impaired assets, transparent accounting accompanied by supervision and evaluations, and professional management that is independent and free from political interference.

Future areas of research concern above all the need for a much stronger empirical and analytical base for discussion of CGS. CGS are under-researched and subject to less rigour and weaker standard practices for institutional assessment than commercial banks or microfinance institutions are.

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Acronyms

aBi	Agribusiness Initiative Trust (Uganda)
ACGSF	Agricultural Credit Guarantee Scheme Fund (Nigeria)
AFD	French Development Agency
AGRA	Alliance for a Green Revolution in Africa
BIS	Bank of International Settlements
CBN	Central Bank of Nigeria
CGS	credit guarantee system
CGTMSE	Credit Guarantee Fund Trust for Micro and Small Enterprises (India)
CIS	Commonwealth of Independent States
DANIDA	Danish International Development Agency
DCA	Development Credit Authority (USAID)
DFID	Department for International Development (UK)
DICGC	Deposit Insurance and Credit Guarantee Corporation (India)
EIF	European Investment Fund
EU	European Union
FAO	Food and Agriculture Organization of the United Nations
FAST	Finance Alliance for Sustainable Trade (Canada)
FEGA	Fondo Especial de Asistencia Técnica y Garantía para Créditos Agropecuarios (Mexico)
FIG	Fonds International de Garantie (RAFAD)
FIRA	Fideicomisos Instituidos en Relación con la Agricultura (Mexico)
GF	guarantee fund
gov't	government
IBRD	International Bank for Reconstruction and Development
IFAD	International Fund for Agricultural Development
IFC	International Finance Corporation
IMF	International Monetary Fund
MFI	microfinance institution
MIGA	Multilateral Investment Guarantee Agency (World Bank Group)
MIS	management information system

MLI	member lending institution (CGTMSE, India)
MSMEs	micro-, small and medium enterprises
OECD	Organisation for Economic Co-operation and Development
PASS	Private Agriculture Sector Support (United Republic of Tanzania)
PROPARCO	Promotion et Participation pour la Coopération Economique
RAFAD	Research and Applications for Alternative Financing for Development
RDF	Rural Development Foundation (Estonia)
SBA	Small Business Administration (United States of America)
SBDC	Small Business Development Corporation, now Business Development Company Ltd (Trinidad and Tobago)
SCP	Special Credit Programme (Japan)
SDC	Swiss Agency for Development and Cooperation
SIDBI	Small Industries Development Bank of India
SMEs	small and medium enterprises
UN	United Nations
UNDP	United Nations Development Programme
UNIDO	United Nations Industrial Development Organization
USAID	United States Agency for International Development

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Chapter 1
Background and introduction

BACKGROUND

The collateral requirements of banks can pose a serious challenge for farmers or rural micro- and small entrepreneurs trying to source funding for business or farming. In many countries around the world, credit guarantees are implemented as a partial substitute to conventional collateral. The design of guarantee systems has evolved to address the new and changing needs of intermediary financial service providers in areas such as portfolio concentration risks and the capital requirements for cushioning against lending risks. At the public policy level, guarantee systems are an instrument for facilitating lending to specific sectors considered to be policy priorities. Taken together, guarantee systems hold promise and provide attractive features for borrowers, financial institutions and policy-makers alike. This explains the current interest in guarantees as an instrument in development finance. However, empirical evidence regarding the performance of different types of guarantee is mixed. In general, newer forms of portfolio guarantee, and guarantees provided to profitable rather than merely promotional sectors appear to fare better than others.

This study builds on a 1998 FAO publication entitled *Credit guarantees – an assessment of the state of knowledge and new avenues for research* (FAO, 1998). The time span of approximately 15 years since then provides an opportunity for assessing observations made in 1998 and comparing them with recent developments in the field. Much has been learned, contexts have changed and new models have been developed. Recent developments include a shift from a simple individual guarantee mechanism towards portfolio and specialized types of guarantee, and a trend for operating guarantee systems through specialized legal entities with limited political influence, although national public and international funds continue to represent the lion's share of guarantee fund (GF) capitalization in development finance.

TARGET AUDIENCE

The study has been compiled primarily for decision-makers at the domestic/national and international levels, in both the public policy and financial sector spheres. Financial service practitioners and other parties involved in rural development finance, such as commercial banks, microfinance institutions and other financial service providers; FAO project office staff, partnering ministry officials, scholars and academics may also find the study useful.

RATIONALE AND PURPOSE

The study takes into account a number of detailed and extensive worldwide stock-taking exercises carried out over the past two decades regarding GFs as an instrument for development finance. It attempts to stratify and focus analysis and findings with regard to: i) credit guarantee arrangements focusing on rural small and medium enterprises (SME) and micro-, small and medium enterprises (MSMEs) and the agriculture sector; and ii) *a priori* definitions of the internally agreed hypotheses to be tested to avoid providing a mere stock-taking exercise and general policy recommendations.

The *key hypotheses* guiding this study can be summarized as follows:

i. *New and different arguments for CGS:* Risk-sharing mechanisms have regained prominence in development finance because of excess liquidity in the banking system, the emergence of microfinance institutions (MFIs) with refinancing requirements, and internal lending restrictions in the sectors that are prioritized for development finance.

ii. *Improved scope for sustainable GF arrangements:* Over the past two decades, cost-covering GF arrangements with a medium-term sustainability perspective have been established in developing economies because of improved scheme design, incentives (particularly to participating banks) and efficiency gains from linking guarantees to ratings and credit information services. The specific design parameters of these arrangements need to be highlighted and their potential for replication discussed.

iii. *Development goals and specific objectives:* GF arrangements that are governed by considerations other than the prudent and reasonable sharing of financial risk among the different partners in a credit contract are likely to fail.

iv. *Forms of incorporation:* GF arrangements are organized in various corporate or legal forms, ranging from publicly managed financial institutions, State-funded companies and government counter-guaranteed corporations to independently managed and privately owned institutions. Independent private corporate entities, credit guarantee foundations or associations, mutual guarantee associations and specialized single-purpose guarantee corporations operating at the national level are more likely to succeed.

v. *Operating and implementation parameters:* Parameters regarding the percentage of risk shared, the claim procedures and timings of claim submissions, and the fee arrangements have a particularly strong bearing on the market acceptance and eventual success of a scheme.

vi. *Monitoring and supervision:* Proper design and monitoring arrangements, including automated management information systems (MIS) play a key role in the costs of administering credit guarantee systems (CGS), and thus eventually in a system's success or failure.

STRUCTURE OF THE DOCUMENT

This document commences with a definition of GFs. Chapter 2 details what has been learned about this instrument since it first became operational less than eight decades ago, and outlines some major institutional models and current actors. The cases for and against guarantees are made, and the worldwide and regional incidences of guarantee systems past and present are presented in overview.

Chapter 3 introduces four detailed case examples of guarantees for agriculture, agribusiness and rural enterprise development. These are followed by a tabular overview of the main design and implementation benchmarks for each of the case examples. Emerging trends and approaches in the application of GFs are outlined in chapter 4. The importance of empirical studies and independent evaluations is underscored, and emerging trends in ownership of GF models and governance are outlined. The chapter ends with a summary of future potential growth areas for guarantees and words of caution regarding the challenge of managing the administration costs and claims on GFs in ways that establish sound prospects for sustainability.

The final chapter (5) brings together the issues discussed throughout the rest of the document and makes observations and recommendations from the perspective of the key hypotheses. A detailed table outlines current practice – which is often unsustainable – and provides recommendations for policy-makers and GF managers regarding each of the six underlying research hypotheses.

Chapter 2
Credit guarantees – what we know

OVERVIEW

Credit guarantees are one of a pool of instruments for risk mitigation and credit enhancement measures. These range from very simple to complex arrangements using a blend of structured finance instruments, such as subordination and portfolio concentration limits. Credit enhancement measures mainly include credit derivates of different sorts that are treated in similar ways to credit guarantees in the Basel II and Basel III framework (discussed in the last section of this chapter). Rather than selecting one instrument and rejecting others, corporate finance applies a mix of different instruments, including guarantees from the European Investment Fund (EIF) and other highly rated financial promotion agencies such as Germany's KfW Banking Group and the International Finance Corporation (IFC).[1]

Credit guarantees can operate at different levels, with the top levels in many cases taking the form of investment guarantees rather than loan guarantees. Of the 23 largest microfinance investment funds, three offer investment guarantees on MFI or SME loan portfolios.[2] In other cases, a donor uses a guarantee as an instrument to finance one or more recipient financial service providers. For microfinance alone, it is estimated that the amount of loan guarantees outstanding to support MFIs is at least US$500 million (2007).

Among donors, the guarantee instrument is utilized above all by private sector funding subsidiaries of bi- or multilateral donor agencies. An example is the support of the Swiss Agency for Development and Cooperation (SDC) to the Bangladeshi Shakti Foundation through provision of a guarantee.

At the next level, banks or MFIs seek guarantees for their loans to specific priority target clients. CGS can back transactions between international and local partner banks.

[1] Glaubitt *et al.* (2008: 358) narrate the complex nature of the sale of part of Procredit Bank Bulgaria's SME and micro-enterprise loan portfolio to a Bulgarian special purpose vehicle for loan proceeds with a revolving promissory note that was adjusted monthly to reflect current portfolio balances. The guarantee was used to provide cover to the portion of senior notes in the special purpose vehicle pool. This raised the notes' rating from BBB to AAA, making possible the participation of Deutsche Bank, which can purchase notes only with the best quality and rating. Through the guarantee, the quality of the pool of investors was thus enhanced.

[2] The Netherlands' Hivos-Triodos Foundation offers 8 percent of its total MFI investment funds as guarantees. The share is smaller for the church-based and very innovative Oikocredit (also Netherlands) investments and the French *Solidarité Internationale pour le Développement et l'Investissements.*