Do Credit Guarantees Lead to Improved Access to Financial Services?

Recent Evidence from Chile, Egypt, India and Poland

Commissioned by

Financial Sector Team, Policy Division
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Work undertaken by Fred Bennett, Alan Doran and Harriet Billington of Enterplan Limited. This working paper summarises findings of study commissioned by Financial Sector Team, Policy Division. The opinions expressed in this working paper do not necessarily represent official policies.
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Executive Summary

This study seeks to assess the contribution of Credit Guarantee Schemes (CGS) to financial sector deepening, which means increasing access to financial services for those who previously had restricted or no access; and increased provision by financial institutions to such clients of products and services relevant to their needs. The study was designed to determine whether sustainable changes in the behaviour of lenders towards the SME sector come about as a direct or indirect result of CGS activity. The result should be improved provision of products and services appropriate to SMEs and thus access by SMEs to financial services.

The central question of the study is whether CGS result in sustainable changes in the behaviour of lenders towards those markets to which the CGS introduces them.

A case study approach was used, focusing on four CGS where financial sector deepening was anticipated based on preliminary research. The case studies selected were: Fondo Garantia para Pequenos Empresarios (FOGAPE), Fund of State Guarantee for Small Industrialists, Chile; Credit Guarantee Company for Small and Medium Enterprises (CGC), Egypt; Credit Guarantee Fund Trust for Small Industries (CGTSI), India; and Lublin Development Foundation (LDF), Poland.

The study is not a survey and does not seek to compile a catalogue or typology of CGS. By selecting only those CGS that showed prima facie evidence of success, considerations of CGS design were specifically excluded from the scope of the study, although CGS-level factors as they relate to philosophy and approach were included. The focus of the study is on banks participating in CGS and their attitudes to the target market. Since most banks were unwilling to divulge data on their non-guaranteed portfolio, the study relies more on qualitative than quantitative analysis.

Conclusions

The study demonstrated that financial sector deepening has occurred in the case study countries and that it can reasonably be attributed in part to the operations of CGS. This was more apparent with respect to direct1/ deepening: causal links were not clear enough to confidently identify instances of indirect deepening.

Credit guarantee schemes (CGS) are effective in promoting sustainable changes in lender behaviour, leading to financial sector deepening, in situations where certain specific factors for success pertain. The key “factors for success” (and, by corollary, the factors for failure) necessary for CGS to effectively promote financial sector deepening include those set out in the table below. While it is difficult and to some extent subjective to prioritise these factors, we have attempted to do this by arranging the factors in an order that, in our opinion, represents their relative importance (most important factors first), separately for Macro and Micro factors.

1/ We found it useful terminology to distinguish between direct deepening, which refers to effects linked directly to the current use of guarantee products by banks, from indirect deepening, which refers to broader effects on bank behaviour brought about by their experience of guarantee usage.
## Factors for Success

in rough order of importance

<table>
<thead>
<tr>
<th>Macro (Enabling Environment) Factors</th>
<th>Factor for Failure</th>
</tr>
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<tbody>
<tr>
<td>1 an open, competitive banking environment wherein there are a number of independent banks, a majority of which are interested in expanding their client base, establishing niche markets, or protecting market position;</td>
<td>a thin banking sector that is controlled by a few powerful vested interests, in which banks are sufficiently profitable with their existing, limited clientele to support the financial and/or political ambitions of those controlling interests;</td>
</tr>
<tr>
<td>2 a dynamic and/or expanding business sector within which viable opportunities are available for exploitation by new entrants including MSMEs;</td>
<td>a thin business sector that is not under pressure to change or reform, in particular to become more inclusive;</td>
</tr>
<tr>
<td>3 a policy environment wherein initiatives are coordinated and reinforcing and other government or donor initiatives do not crowd out market-driven initiatives, in particular through provision of competing subsidised credit or other below-market financial products and services, including (but not limited to) credit guarantees;</td>
<td>a policy vacuum or a fragmented policy environment where clear signals are not conveyed about the importance of the SME sector and the means by which it is appropriate to promote and develop it, and where a multiplicity of competing or conflicting approaches can therefore exist at the same time;</td>
</tr>
<tr>
<td>4 a monetary and regulatory environment that is conducive to lending to SMEs, in particular with sufficient liquidity and stable interest rates that allow for appropriate risk/return pricing;</td>
<td>restricted liquidity for SME lending and/or excessive interest rate risk that discourages opening up new markets;</td>
</tr>
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<td>5 a framework for business (political, policy, legal, regulatory and social) that, in its application as well as its theory, is supportive of enterprise in all its forms including MSMEs;</td>
<td>endemic corruption and/or incompetence that distorts and/or restricts the operation of market forces and discourages MSMEs from entering the formal economy;</td>
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<tr>
<td>6 support from a competent agency (such as the Ministry of Finance, or more usefully the central bank and/or banking supervisory authority) that takes an imaginative, positive and well-informed interest in the SME sector and its financing problems and which works to enhance the enabling environment for SMEs;</td>
<td>Interference from an ill-informed government agency that takes an ad-hoc approach to problems in the financial sector and uses the financial sector as a tool to address policy issues;</td>
</tr>
<tr>
<td>7 a credit bureau that provides effective and efficient access to credit information on SMEs that helps improve the ability of banks to assess risk of lending to SMEs.</td>
<td>no available credit information on SMEs or partial or unreliable information that does not help banks to assess risk.</td>
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### Micro (CGS) Factors

<table>
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<tr>
<th>Factor for Success</th>
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<tbody>
<tr>
<td>8 emphasis on promoting dynamism through fostering of competitive behaviour among participating lenders, including a high degree of transparency with respect to participating bank performance.</td>
<td>lack of transparency or competition; low expectations of the potential of partner lenders to effectively address the needs of the SME sector.</td>
</tr>
<tr>
<td>9 a “financial sector” approach to CGS design that focuses on the goal of achieving a permanent deepening of the financial sector;</td>
<td>a “social sector” approach that focuses exclusively on a short-term goal of pushing finance to the SME sector and the use of financial institutions as conduits for that purpose;</td>
</tr>
<tr>
<td>10 an understanding of and empathy with market forces, particularly for providers of financial intermediation services;</td>
<td>an emphasis on the social obligation of lenders or compliance with laws, regulations or policies</td>
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</table>
A key objective of a CGS should be to enable each bank to find its own way of profitably using the CGS mechanism to extend its services into marginal markets. It is insufficient for development-orientated agencies, most of which are government or donor funded, to point to increased usage by lenders of credit guarantees as justification for their continued existence. In other words, provision of credit guarantees, even at steadily increasing levels, is an inadequate objective for a CGS. The proper objective for a CGS is to promote financial sector deepening.

**CGS serve as accelerators, not drivers, of financial sector deepening. In other words, CGS are not a necessary condition for financial sector deepening. In fact, where the need for financial sector deepening is greatest, CGS are least likely to be successful in promoting that deepening.**
Introduction

Background

1 Much of the work undertaken to assess the impact of Credit Guarantee Schemes (CGS) has concentrated on the impact on the borrower (the small entrepreneur) and the small enterprise itself. Studies related to the impact on the guarantor and lender has been largely limited to (a) the extent to which additional (as opposed to substituted) lending took place within the context of the guarantee, and (b) the mechanisms, design and management of guarantee schemes. Little emphasis has been placed on the medium to long term impact on the lending institutions involved in the guarantee scheme and the wider financial sector – their attitude to new markets, particularly at the lower end of the scale, and their ability to serve them. Despite the difficulties of examining such impact, it is an important analysis to undertake and has far-reaching implications in increasing understanding of whether such mechanisms as credit guarantee schemes can truly contribute to sustainable changes within the financial sector, particularly in terms of institutional behavioural changes that ultimately result in financial sector deepening.

The DFID Study

2 The DFID study\(^2\) seeks to determine the contribution of CGS to financial sector deepening. By financial sector deepening is meant increasing access to financial services for those who previously had restricted or no access; and increased provision by financial institutions to such clients of products and services relevant to their needs. The study was designed to focus on changes in institutional attitudes towards the SME sector, as these are seen as critical to improved provision of products and services appropriate to SMEs and thus access by SMEs to financial services.

3 The focus of the study on financial sector deepening does not imply that this is the only acceptable justification for CGS. CGS may have other developmental benefits: for example, there may be changes in borrower behaviour that result from CGS activities, which contribute to financial sector deepening, including: increased willingness to access formal financial sector finance; increased knowledge and use of mainstream financial and business management tools and techniques; and increased movement of enterprises from the informal to the formal economy.

4 The study focused on the Small and Medium Enterprise (SME) sector due to its acknowledged importance for national productivity, employment and poverty reduction, and because the preponderance of CGS have attempted to address the need for finance of this sector. Attention was also paid to micro enterprises where these were included in the target group by CGS.

5 The central question of the study is whether CGS result in sustainable changes in the behaviour of lenders towards those markets to which the CGS introduces them. We found it useful terminology to distinguish between direct

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\(^2\) The Terms of Reference are attached as Appendix A1.
deepening, which refers to effects linked directly to the current use of guarantee products by participating banks, and indirect deepening, which refers to the broader demonstration effects on the financial sector, brought about by their exposure to guarantee usage.

**Approach and Methodology**

6 The Terms of Reference for the study called for the use of the researcher’s specific knowledge of CGS, different financial sector markets, financial sector institutions and secondary literature, and researchers were selected that had long-term industry-specific expertise in the area of CGS. It was concluded that the most effective use of this knowledge could be made by bringing it immediately to bear on the formulation of a thesis, which the study then attempted to prove or disprove through four case study investigations. This approach enabled careful targeting of limited resources to achieve the best possible result in terms of insights into the potential of CGS to promote financial sector deepening.

7 The research team carefully considered the strengths and weaknesses of the case study approach and the degree to which conclusions or insights might be drawn from the findings. They concluded that the case study methodology would, in fact, provide the necessary research framework to prove a carefully constructed thesis, because:

- a methodology using four distinct case studies from differing environments would enable collation and “triangulation” of data, allowing conclusions and insights to be drawn beyond any single CGS case while also providing outputs of practical use to each individual CGS;

- the nature of the subject under investigation – the attitude of lenders to a particular potential target market – was by its nature accessible only through interviews and the case study methodology reflected the nature of the data available; and

- each CGS case study would involve a significant number of stakeholders (the CGS administrative unit and several participating financial institutions) and complex personal relationships, requiring a flexible and subjective research methodology.

8 The central question of the study pertains to lender, not CGS, behaviour. The lack of a direct link to CGS partner banks through donors, or even a list of participating banks to serve as a starting point, posed additional methodological and resource difficulties to data collection.

9 The following process was therefore followed during the course of the study.

- An internet literature review and industry survey was conducted to identify secondary studies relevant to the study and create a longlist of CGS which had potential to be one of the four case studies. While the research team felt

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3/ Enterplan Limited was contracted to provide a team of researchers, which consisted of F Bennett, Team Leader; A Doran, Senior Researcher; and H Billington, Researcher. Richard Boulter, Douglas Pearce, Sukhwinder Arora, Karen Ellis and Suzanne Parkin of the DFID Financial Sector Team provided invaluable contributions, for which the research team is grateful.

4/ A selected bibliography is attached as Appendix A2.
a review of secondary literature would quite likely be useful, it was clear that, by itself, it would be unlikely to reveal sufficient previously unknown sources of information to answer the central question of the study.5/

- Using agreed criteria for selection and in consultation with DFID, four case studies were selected for in-depth analysis. This was not an unbiased process: the four case studies were selected on the basis of prima facie evidence that they had contributed to financial sector deepening. CGS that were reported to be failures were consciously excluded from the longlist.

- Using the agreed tests, the four case study CGSs were examined to determine whether there was evidence of success in promoting financial sector deepening.

- The findings were then applied in an attempt to prove or disprove the agreed thesis.

**The Thesis**

10 The basis for the thesis is the premise that CGS as tools for promoting financial sector deepening are useful in certain situations, each individual situation consisting of a set of factors that, in combination, are conducive to the successful application of CGS for promoting financial sector deepening. The objective is to identify the key factors that are most influential over the potential of a CGS to successfully promote financial sector deepening. All the factors examined were above the detailed design level: it was assumed that all CGS were competently designed and any CGS that had obvious design flaws was excluded from the study.

11 The thesis includes some “factors for success”, along with “factors for failure” which served to further explain and clarify the meaning of the factors for success. Success in this context means success at promoting financial sector deepening. The factors were classified into Macro and Micro factors. Macro factors deal with the larger enabling environment or framework for business and finance, including the political, policy, legal, regulatory and social environments. Micro factors deal with the design philosophy and approach of the CGS which, while above the level of detailed design, are specific to the individual CGS.

12 The thesis developed is as follows:

“Credit guarantee schemes (CGS) are effective in promoting sustainable changes in lender behaviour, leading to financial sector deepening, in situations where certain specific factors for success pertain. The key ‘factors for success’ (and, by corollary, the factors for failure) necessary for CGS to effectively promote financial sector deepening include those set out in Table 1.

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For example, the 1997 global review of credit guarantee schemes (Jacob Levitsky and Alan Doran, *Credit Guarantee Schemes for Small Business Lending, A Global Perspective*, Graham Bannock and Partners Limited, DFID, 1997) asserted the long-term potential of CGS (a summary of the Bannock study is given in Appendix A10). However, the central question of the current study - whether CGS result in sustainable changes in lender behaviour and thus contribute to financial sector deepening – probes beyond the scope of the 1997 global survey, which was therefore of limited assistance.
## Table 1: Factors for Success

<table>
<thead>
<tr>
<th>Factor for Success</th>
<th>Factor for Failure</th>
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<tr>
<td><strong>Macro Factors</strong></td>
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<td>1 an open, competitive banking environment wherein there are a number of independent banks, a majority of which are interested in expanding their client base, establishing niche markets, or protecting market position;</td>
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<td>4 a framework for business (political, policy, legal, regulatory and social) that, in its application as well as its theory, is supportive of enterprise in all its forms including MSMEs.</td>
<td>• endemic corruption and/or incompetence that distorts and/or restricts the operation of market forces and discourages MSMEs from entering the formal economy.</td>
</tr>
<tr>
<td><strong>Micro Factors</strong></td>
<td></td>
</tr>
<tr>
<td>5 an influential “champion” (or champions) within the lender(s) who actively promotes the CGS for appropriate commercial reasons;</td>
<td>• lack of support or lack of understanding of the commercial logic of the CGS within the lender(s);</td>
</tr>
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<td>6 a “financial sector” approach to CGS design that focuses on the goal of achieving a permanent deepening of the financial sector;</td>
<td>• a “social sector” approach that focuses exclusively on a short-term goal of pushing finance to the SME sector and the use of financial institutions as conduits for that purpose;</td>
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<td>7 an understanding of and empathy with market forces, particularly for providers of financial intermediation services;</td>
<td>• an emphasis on the social obligation of lenders or compliance with laws, regulations or policies</td>
</tr>
<tr>
<td>8 a long-term approach that emphasises institutional and financial sustainability, with objectives directly related to financial sector deepening, even if project interventions are short or medium term in duration;</td>
<td>• a project approach that focuses on short-term objectives that are limited to the period of the project intervention, rather than directly related to long-term financial sector deepening;</td>
</tr>
<tr>
<td>9 extensive transfer of appropriate lending “technology” in terms of policies, procedures, methodologies and systems through carefully focused technical assistance;</td>
<td>• reliance on targets for achievement of project lending objectives without regard for the ongoing sustainability of institutional processes;</td>
</tr>
<tr>
<td>10 a participative approach that achieves a balanced partnership between donors, CGS and lenders for achievement of agreed objectives;</td>
<td>• a paternalistic approach that imposes a CGS project on reluctant lenders who do not understand or do not agree with the stated objectives;</td>
</tr>
<tr>
<td>11 ownership by lenders of the CGS stemming from clear and significant benefits to lenders in terms of assistance to open up new markets for profitable commercial exploitation.</td>
<td>• coercion of lenders through a “carrot” (non-transparent benefits unrelated to financial sector deepening) and/or “stick” (pressure from political or regulatory authorities) approach.”</td>
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A factor for success and its corresponding factor for failure generally set out extreme situations which are not likely to occur in reality. Each factor was therefore evaluated using a grading system, as shown in Table 2.

**Table 2: Factor Assessment**

<table>
<thead>
<tr>
<th>Factor</th>
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</table>

where: 1 = “very much so”; 2 = “to some extent”; 3 = “only slightly”; 4 = “not at all”, with reference to the factor for success.

The assessment tables were structured through the wording of the text so that responses that are positive indicators for financial sector deepening ranked 1 while responses that are negative indicators ranked 4. This provides a simple overall positive or negative visual indicator.

**Tests**

The tests brought to bear to determine whether an individual CGS was successful in promoting financial sector deepening are generally able to indicate the relative degree of impact on financial sector deepening even where quantitative data are unavailable. The tests covered:

- **appropriate design philosophy and approach:**
  - do the participating banks view the CGS as a beneficial exercise that helps/helped to open up new markets, or as a donor or government driven programme imposed on them?
  - are the benefits derived from the CGS by the participating banks clear and significant? can participating banks articulate/quantify the benefits that they derived from the CGS? is lending to SMEs, including CGS supported lending, seen as a profitable / core business activity?

- **potential for impact:**
  - did many banks participate in the CGS? were most branches of each bank included? did most credit officers handle CGS loans?
  - were the lending targets of the CGS achieved? were most loans to the specified target group?
  - were a significant proportion of loans made to first time borrowers? were many of these new customers of the bank? were many of these start-up businesses?
  - has the CGS achieved operating self-sustainability or full financial self-sustainability? is this an explicit objective of the CGS?
• **impact on participating banks:**

  - has the institutional attitude to the relative risk and return of lending to the SME sector changed significantly as a result of the CGS? is this attitude prevalent and consistent at all levels of management and line staff?

  - has the overall level of lending by participating banks to SMEs continued to increase (if the CGS is active, either through increasing multiplier rates or lending without guarantee additional to lending supported by guarantee; or if the CGS has become inactive, through maintenance of the level of lending to SMEs even though guarantees are no longer available)?

  - if overall levels of lending by participating banks to SMEs have fallen, is the reason explainable by systemic failures in the financial framework or enabling environment (for example, prohibitive restrictions on the type of collateral that can be accepted by lenders) rather than loss of interest in the SME market by the participating banks?

  - would participating banks be interested in having the CGS extended / reinstated?

  - have the terms and conditions of lending to the SME sector changed since the start of the CGS (for example, have maturities increased, have maximum loan amounts increased, have collateral requirements changed)?

  - has the CGS induced learning in the participating banks, in terms of transfer of SME lending technology in the broad sense (policies, procedures, methodologies and practices)? are loan officers trained or are they being trained in this lending technology?

• **impact on the financial sector:**

  - have lending volumes to SMEs grown at greater than the growth in GDP attributable to SMEs?

  - have other lenders started or increased lending to the SME sector since the start of the CGS? has competition between lenders for business in the SME sector increased?

  - has the SME sector grown at a faster rate after the CGS than before?

• **impact on the enabling environment:**

  - have default rates in the CGS decreased (positive impact) or increased (negative impact) over the duration of the scheme? have default rates in SME lending in the CGS and generally been lower or higher than default rates in other sectors?

  - has the political, policy, legal and/or regulatory environment become more conducive to SME activity since the CGS started? to what extent do lenders attribute this change to the activities of the CGS and its participating banks?
on the other hand, has the CGS prevented or delayed other developments which would have been conducive to SME banking as a whole?

16 The tests were incorporated into two structured interviews; one for the CGS management unit itself and another for a sample of participating financial institutions.6/ 

17 During the course of the study, we found it useful to distinguish between two types of financial sector deepening. We use the term “direct deepening” in the context of the case studies to refer to effects linked directly to the current use of credit guarantee products by banks. Indirect deepening refers to the broader effects on bank behaviour brought about by their experience of guarantee usage or their observation of other banks’ experience of guarantee usage.

Selection of Case Studies

18 The criteria for selection of the four case studies take into account the purposes for which DFID is undertaking the Study. In order for insights derived from the Study to be useful, they need to be applicable to ongoing and new financial sector deepening initiatives. We therefore take into account current development thinking and trends in financial sector development interventions to ensure that lessons learned are relevant to future projects. Lessons that have already been widely accepted and applied are not as useful as new insights.

19 Established and nascent trends in the area of financial sector deepening over the past decade include:

- streamlining of delivery methods to achieve low transaction costs and financial sustainability;
- down-scaling of operations by formal financial institutions to profitably serve new markets;
- application of innovative new technologies to enable delivery of financial services to remote, isolated and previously unbankable clients; and
- entry of non-traditional players into financial and other markets to address previously neglected bottom-of-pyramid markets.

20 A preference for CGS for which there was prima facie evidence, derived from the internet literature search and industry survey, that the CGS exhibited progressive thinking and innovation which was judged to be characteristic of current thinking and nascent trends in the area of financial sector deepening. Examples of progressive thinking likely to be found in some but not all CGS include: an emphasis on cost effective, market-driven delivery; application of client-friendly technology; opening up of new markets to financial services; and a focus on financially sustainable institutions.

6/ The Structured Questionnaires, together with an introduction provided to all respondents, are attached as Appendix A3.
Other factors that influenced the selection of candidates for the case studies included:

- geographical spread (although rigid country or regional requirements were not imposed and there was no requirement to make the selection of countries representative of the countries that are the focus of DFID activities);
- age of the CGS (to allow for time for financial sector deepening impacts to become apparent), generally a minimum of 5 to 8 years from inception;
- scale of the CGS, so that a significant impact in terms of volume of lending, number of borrowers and resulting economic growth could be anticipated;
- number of participating banks, in order that distortions to the market are avoided and competition was likely to leverage the positive impacts of the CGS;
- co-operation between donor and government initiatives that increases the potential for the CGS to have an impact on financial sector deepening; and
- CGS in developing rather than developed countries. It was agreed that, while the consultants may spend up to 10 percent of their available time for literature search investigating relevant studies on CGS in developed countries, all case studies to be selected would be situated in a developing country context.

The case studies selected\(^7\), \(^8\) were:

- Fondo Garantia para Pequenos Empresarios (FOGAPE), Fund of State Guarantee for Small Industrialists, Chile;
- Credit Guarantee Company for Small and Medium Enterprises (CGC), Egypt;
- Credit Guarantee Fund Trust for Small Industries (CGTSI), India; and
- Lublin Development Foundation (LDF), Poland.

\(^7\) The annotated long list of candidates CGS is attached as Appendix A4.
\(^8\) The case studies are attached as Appendix A5 (FOGAPE, Chile); Appendix A6 (CGC, Egypt); Appendix A7 (CGTSI, India); and Appendix A8 (LDF, Poland).
Lessons and Insights

Summary of Case Studies

Fogape Credit Guarantee Scheme, Chile

The CGS called Fogape in Chile was chosen as one of the four case studies because there was evidence from preliminary desk research that, since its reform and relaunch in 2000, there has been an explosion of interest in its guarantee offerings on the part of participating banks, so that the number of independent private-sector commercial banks participating in the CGS and volume of operations of the CGS had become large by 2003. In addition, the element of competition between participating banks was built into the design of the scheme. Both of these had been suggested in the thesis as factors for success for CGS in promoting financial sector deepening.

The main evidence for financial sector deepening of the direct kind is summarised below.

- The number of banks addressing the SME sector through the CGS route had increased from 3 to 18 following its relaunch.
- Banks generally cited the CGS as an important tool, although not the prime one, in their strategic approach to the whole sector.
- All banks interviewed stated that:
  - their interest in the CGS products was commercial and profit-oriented and not a compliance with government policy on SME support;
  - their use of CGS had enabled them to extend the outreach of their commercial lending operations beyond the frontier that applied before the CGS products were available. This extension of outreach was in terms of borrowers who would not otherwise get access to funds, or better terms and/or greater access for existing customers. The nature and degree of “additionality” varied from bank to bank and could not be precisely quantified. Note that with this CGS there is no requirement for the lender to refrain from taking other available collateral;
  - with the exception of one bank that had internal system problems, all banks wanted to increase their use of the CGS in future;
  - 2,500 front line bankers had been trained in the use of the guarantee products to service small and micro enterprises; and

Summary characteristics of the four CGS studied are provided in Appendix A9.
• banks had responded to their competitors’ introduction of new CGS-assisted lending products by matching their rivals’ offerings, thus broadening the choice available to SMEs.

25 In addition to the effect on banks, the successful take-up of Fogape products had led CORFO, a government-owned financial support agency, to plan the introduction in 2004 of a similar product to that of Fogape, aimed at the next SME sub-segment upwards in terms of business size.

26 The average risk share of the guarantee has been falling, from 79 percent in 2001 to 71 percent in 2003, so that banks are taking more of the risk over time.

27 There was no conclusive evidence for indirect deepening. Banks denied that their non-guaranteed SME lending operations had been generally affected by their experience with guaranteed lending. However, several admitted that it had already resulted in some marginal cases of departures from existing policy, and others that it could be an effect in the future. One bank had already considered ways in which it could retain the guarantee premium by taking on the whole risk while another stated that the high quality information about arrears and losses in the SME sector coming from Fogape10 was already leading to internal discussions about reviewing risk pricing for non-guaranteed loans.

Credit Guarantee Company for Small and Medium Enterprises (CGC), Egypt

28 The CGC in Egypt was chosen as one of the four case studies because there was evidence from preliminary desk research that it had achieved sufficient scale and operational efficiency to be financially sustainable. Other factors that interested the researchers included its legal form as a private joint stock company, and its relationship with CGC Consult, a joint venture consulting company.

29 The main evidence for financial sector deepening of the direct kind was:
• from 9 original shareholder banks, CGC has expanded to 34 banks under contract;
• partner banks interviewed generally cited the guarantee provided by CGC as essential to their ability to service the SME sector; and
• some of the more active partner banks are developing increasingly large portfolios of loans to SMEs, using CGC guarantees without additional security, thus lending with only partial security coverage of the funds at risk.

30 All banks interviewed stated that the CGC guarantee was an essential factor in their ability to deal with the SME sector and their use of the CGC guarantee had enabled them to extend the outreach of their commercial lending operations beyond the frontier that applied before the CGC products were available. This extension of outreach was to borrowers who would not otherwise have had access to loan funds because of their lack of credit history and acceptable security. CGC does not oblige the lender to refrain from taking other available security - some do while other do not;

10/ Detailed results for the whole portfolio of guaranteed loans, analysed by bank, are distributed each month at the informal inter-bank meeting. This information is uniquely up to date and precisely targeted to that sector and is not available from any other source.
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31 Those banks that had decided to target the SME sector were very conscious of the competitive advantage of using CGC lending products to match their rivals’ offerings and increase market share. Not all of CGC’s partner banks had made a strategic decision to set the SME sector as a target market: some banks were focused on other sectors and had not put any priority on the SME sector, while others expressed some interest but had experienced relationship problems or used alternative support mechanisms for their approach to the sector (largely the Social Fund for Development, which offers subsidised interest rate loans).

32 The most active partner banks indicated that their interest in the CGC product was commercial and profit-oriented in nature. However, some banks indicated that their involvement with CGC came out of a desire to support government policy on SME development or a perceived social obligation.

33 CGC had an impact on the participating banks by exposing them for the first time to SME lending policies and mechanisms. CGC also influenced its partner banks by continually reviewing best practice lending policies and mechanisms and working with participating banks to develop their understanding and awareness of this market segment.

34 The extent of CGC outreach represents a maximum of about 3 percent of the total number of SMEs, according to a 1996 census. Given this limited outreach, we conclude that financial sector deepening from CGC operations has been limited. Competing mechanisms for support of banks’ lending to SMEs, primarily the Social Fund for Development, are not market driven in the way CGC is and tend to reduce the potential market for CGC products.

35 Evidence for indirect deepening was limited. Banks denied that their non-guaranteed SME lending operations had been generally affected by their experience with guaranteed lending. In fact, most banks indicated that they would be unable to lend to the target markets supported by the CGC products, including SMEs, without a guarantee or other means of support.

Credit Guarantee Fund Trust for Small Industries (CGTSI), India

36 The CGS called CGTSI in India was chosen as one of the four case studies because there was prima facie evidence from preliminary desk research that it was a new scheme dating from the year 2000, which had benefited from the previous experience (good and bad) of the old CGS run for many years by the DICGC (Deposit Insurance and Credit Guarantee Corporation) that it was using modern technology and a simplified but highly professional management approach to relaunch the credit guarantee product in a very large market, and that it had powerful backing in terms of the scale of resources announced to be available for its fund.

37 The evidence suggests that, so far, only very limited financial sector deepening of the direct kind has occurred.

- The penetration of CGTSI is so far very low at a cumulative 18,000 transactions\(^{11/}\), after nearly 4 years, against a target population of 2.3 million registered and 9 million unregistered target firms.

\(^{11/}\) Approximate figure at end August 2004

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- There have been four active banks (over 1,000 transactions each) accounting for 78 percent of the number among the 29 who have so far used guarantees. These banks have so far concentrated on using the guarantee in the smallest loan size range, under Rs 0.5 million (approximately USD 11,000), where there is a standing central bank instruction to make loans collateral free. Average loan size for all transactions to June 2004 was approximately Rs 0.164 million (USD 3,650).

- Only 6.9 percent of all guarantee approvals to March 2004, that is just over 1,000 transactions, were for loans above Rs 0.5 million. The overall average amount guaranteed increased, however, by 43 percent in the 15 months to June 2004, and the trend to larger loans is accelerating.

- Banks interviewed generally cited the CGS as a tool which would enable them to expand their lending to new borrowers, including first generation entrepreneurs, but there was no data to support this attribution.

- Two public sector banks out of four interviewed recognised the CGTSI as having a clear advantage in principle over collateral, but were concerned about borrower resistance to guarantee fees, particularly those charged in the first year.

- The private sector bank saw the CGTSI as an essential tool to attack a small part of a specific market sub-segment, which it would not otherwise be able to address.

38 Upwards of 1,500 front line bankers had been trained in the use of the guarantee to service small enterprises, which, in the absence of collateral, might not otherwise have had access to loans.

39 There was no hard evidence of indirect deepening. Interviews indicated that banks’ non-guaranteed SME lending operations had not been affected by their experience with guaranteed lending.

**Lublin Development Foundation (LDF), Poland**

40 The LDF in Poland was chosen as one of the four case studies because of the historical interest of DFID, which assisted in the establishment of the credit guarantee activities of LDF through the Polish-British Enterprises Project (PBEP), 1995-99. There was also an interest in investigating one regional, as opposed to national, CGS within the overall study. A particular interest was to investigate the transition from donor-funded project to institutionally and financially self-sustaining organisation, and in particular to see if this change initiated or accelerated drift away from the initial project objectives and mechanisms.

41 The main evidence for financial sector deepening of the direct kind was:

- strong competition in the SME sector by a broad cross-section of major and secondary private and publicly owned banks;

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12/ 30 June 2004
13/ From Rs. 0.115 million to Rs. 0.164 million loan size

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- clear focus on provision of financial services to SME by most banks, including dedicated departments and credit officers, specialised products, simplified procedures and targeted marketing;

- strong and increasing competition on both quality and cost of services; and

- reportedly large and increasing direct lending by banks to SMEs without support of guarantees or subsidised funds.

Separating the causality of these positive developments was difficult. It appears that the role of LFP was important when it started operations, when banks were afraid to lend to any SME without a guarantee. Now LFP is more marginal to banks dealing with SMEs as credit guarantees are used only in those instances where viable clients lack sufficient security.

Poland banks remain highly conservative and the researcher felt there was still a role for LFP. However, a comprehensive review of products, models and delivery methodologies is required to make LFP more relevant in a rapidly changing financial sector.

Summary of Key Insights

Enabling Environment (Macro Factors)

A summary of the enabling environments in the countries of the four case studies is set out in Table 3 on the next page, against the four Macro factors of the Thesis as set out in Table 1, above.

During the course of the study, additional factors were identified as being of importance which were not originally included in the Thesis.

- Critical to the success of any market-focused CGS is a climate wherein other government or donor initiatives do not crowd out market-driven initiatives, in particular through provision of competing subsidised credit or other below-market financial products and services, including (but not limited to) credit guarantees.

- Support from a competent agency (such as the Ministry of Finance, or more usefully the central bank and/or banking supervisory authority) that takes an imaginative, positive and well-informed interest in the SME sector and its financing problems and which works to enhance the enabling environment for SMEs is important in raising and maintaining the profile of the SME sector.

- A credit bureau that provides effective and efficient access to credit information on small and medium borrowers is important for banks to increase their ability to assess risk in this sector.

The in-country field studies have proven these factors to be significant to the extent that they are worthy of mention in addition to those in the original thesis. The first of these new factors exhibited itself in three of the four countries selected for case study. Faced with a choice, borrowers will always attempt to maximise their own benefit and will therefore choose the option that costs less, other aspects being equal, whether that is reflected in low interest rates, low fees or reduced likelihood that repayment will be enforced. Faced with such competition, CGS have difficulty in
achieving the scale that is required if they are to have significant influence on financial sector deepening. This restriction on a CGS’s potential to achieve financial sector deepening is independent of its design and management.

47 The second factor is put forward with some trepidation, because it is clear from decades of experience that government direct involvement in financial sector development may have been the cause of many more problems than it has solved. Ill-advised or ad-hoc interventions in the financial sector can cause a multitude of problems, from inefficient public sector banks that dominate the banking sector to multitudes of small, financially and institutionally unsustainable financial institutions. The seeming simplicity of CGS goes a long way to explaining their popularity, however for a CGS to be effective in promoting financial deepening, many disparate factors must be harmonised. While it should perhaps be obvious, a CGS has a much better chance of achieving sufficient scale to influence financial deepening if other factors in the banking and economic sectors are structured in such a way as to also support this goal.

48 The third factor has exhibited itself in the case studies particularly with respect to credit information bureaux that aid banks to overcome the problem of information asymmetry. The issue of information asymmetry is a significant one with respect to achieving a level of comfort on the part of banks that allows them to lend without a credit guarantee, particularly when the client group is new and is one with which the banks have little experience. The existence of a credit bureau is therefore particularly supportive of indirect deepening. There is potential for CGS to offer a similar service to credit bureaux, with respect to its experience with its guarantee portfolio.
### Table 3 Assessment of Enabling Environments (Macro Factors for Success)

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<tr>
<td>1 Chile has a highly rated, competitive and market-driven banking environment with no dominant bank, with most banks interested in expanding their client base, establishing niche markets, or protecting market position.</td>
<td>1</td>
<td>1 Egypt’s banking environment is somewhat open, and increasingly competitive with a number of independent banks, many of which are interested in expanding their client base, but the sector is still dominated by state-owned banks.</td>
<td>2</td>
<td>1 The banking system has substantially improved its operational standards since 1991. Growth of the banking system has been faster than for the economy, at 15 to 20%. However, public sector banks still dominate the sector, banks place too many resources with government, some public sector banks have legacy high NPAs</td>
<td>2</td>
<td>1 Poland has a very competitive banking environment with high penetration of foreign banks, many of which are focused on expanding their SME client portfolios. However, the sector is still dominated by PKO, ex-state-owned bank.</td>
<td>1</td>
</tr>
<tr>
<td>2 Chile has a particularly stable and resilient economy with sound fiscal and monetary policies, relatively well-developed financial system and up-to-date institutions. Liquidity is not constrained.</td>
<td>1</td>
<td>2 Egypt has a monetary and regulatory environment that is in process of reform to make it more conducive to lending to SMEs, with sufficient liquidity and stable interest rates that allow for appropriate risk/return pricing.</td>
<td>3</td>
<td>2 India is moving from a directive to a supportive regulatory environment. RBI still issues specific and detailed guidelines to banks as to how they should conduct their business. There is no shortage of funds for lending.</td>
<td>2</td>
<td>2 Poland’s monetary and regulatory environment is conducive to lending to SMEs, with sufficient liquidity and stable interest rates that allow for appropriate risk/return pricing.</td>
<td>1</td>
</tr>
<tr>
<td>3 A solid period of growth in the 1990s, including for SMEs, was followed by the emerging markets crisis of 1998. Recovery is</td>
<td>1</td>
<td>3 The business sector is hampered by heritage bureaucracy that discriminates against private enterprise, a fragile</td>
<td>3</td>
<td>3 India has experienced rapid economic growth over the last 13 years and the forecast trend is 6% pa. The SME sector is booming in</td>
<td>1</td>
<td>3 The region of activity is somewhat disadvantaged but the business sector is achieving steady growth in viable opportunities, most of</td>
<td>2</td>
</tr>
</tbody>
</table>

Where 1 indicates a very good enabling factor while 4 indicates a very poor enabling factor.
<table>
<thead>
<tr>
<th>FOGAPE (Chile)</th>
<th>CGC (Egypt)</th>
<th>CGTSI (India)</th>
<th>LFP (Poland)</th>
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<tr>
<td>still fragile. SMEs account for about 13% of total sales but are unproductive and contribute little to exports.</td>
<td>economic recovery from prolonged difficult conditions, and an increasing number of viable opportunities for SMEs in some sectors.</td>
<td>numbers and output although this is not even across the country. The economy is vulnerable to high oil prices.</td>
<td>which are for SMEs.</td>
</tr>
<tr>
<td>Chile has a strongly market oriented policy environment, well developed economic, political and legal institutions. Well-respected public credit bureau subscribed by all banks. Corruption index is just below that of USA.</td>
<td>Egypt has an increasingly positive political and policy framework for business which however has been slow to translate into progress with respect to the legal, regulatory and social environment for business. No credit bureau. Corruption remains a problem.</td>
<td>India is moving further towards a full market economy. Credit information and reference sources for the SSI sector are improving, although not yet good. Corruption is a continuing problem.</td>
<td>The government is committed to supporting SME sector development including simplifying the tax system, reducing labour costs, making work relations more flexible and eliminating bureaucratic barriers, however the legal framework still is ranked low in comparison with other regional countries. No credit bureau. Corruption remains a problem.</td>
</tr>
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</table>
CGS (Micro) Factors

49 A summary of the CGS factors is set out in Table 3 on the next page, against the seven Micro factors of the Thesis as set out in Table 1, above.

50 The case studies indicated that the existence of a “champion” for the CGS, while likely very important at the time of the establishment of the CGS, diminishes in importance over the life of the CGS. At some stage, if a CGS is successful, it becomes well-known and starts to rely on its reputation for professionalism and reliability, rather than on a champion within the lender.

51 Similarly, credit guarantees become well-known products that are compared on the basis of the details of their terms and conditions. The ability of the CGS to provide banks with SME lending technology becomes irrelevant as the lender develops its own technology. Instead, CGS can offer other inducements and benefits to lenders, such as up to date and detailed risk information on the SME category. Another important benefit culled from the CGS experience is specific borrower credit information, which can partially substitute for (in its absence), or add to that available from a credit bureau that provides information on small borrowers. Few CGS take sufficient advantage of this potentially attractive benefit.

52 It is clear from the case studies that continual innovation is key to a CGS’s continuing ability to influence lenders. Some CGS studies have continued to “push the envelope”, in some cases to a surprising extent and in unique and unexpected ways; however some have continued to offer the same product, with a gradual diminishment in their influence on lenders.

53 Another aspect that promotes dynamism within a CGS is the fostering of competitive behaviour among lenders in their participation in the scheme.

54 It would appear that a consultative approach to decision-making by CGS, involving their partner banks, is useful in developing good relationships, preventing technical and administrative problems and promoting an atmosphere of trust. However, it is possible that too close a relationship may block innovation in the CGS due to the natural conservatism of banks. The involvement of an outside stakeholder, whether government, a donor or an institutionalised innovator, may be critical in ensuring continued CGS development and effectiveness.

55 All the CGS studied take a financial sector approach, understand and empathise with market forces, and view institutional and financial sustainability as a long-term goal. However, it is apparent that these phrases can mean different things in different environments, and following a market driven strategy may mean very different things in differing economic, political and social environments. To promote a common understanding of what is possible in the context of market-driven financial sector deepening, a forum dedicated to developing communications and international best practice would be invaluable.
### Table 4 Assessment of CGS (Micro) Factors for Success

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<th>Description</th>
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<tbody>
<tr>
<td><strong>5</strong> FOGAPE’s Internal Supervisor, a member of Bank Estado’s top management, and FOGAPE’s Manager help maintain relationships with partner banks.</td>
<td>2</td>
<td>CGC recognises the importance played by senior bank managers and takes care to preserve relationships, but in many cases the original champion (if one existed) is no longer in place in the partner bank. CGC works hard to preserve operational relationships.</td>
<td>3</td>
<td>Following a slow take-up after the launch, the new management team has paid special attention to establishing bilateral relations with banks at top level.</td>
<td>2</td>
<td>At the start, LFP’s connection with the highest level of the bank’s structure was assisted by the fact that the banks were, at that time, regional. Subsequently, as banks became national in nature LFP lost some of its top-level relationships. LFP works to preserve relations at operating levels.</td>
<td>2</td>
</tr>
<tr>
<td><strong>6</strong> FOGAPE epitomises the “financial sector approach”</td>
<td>1</td>
<td>CGC has taken the “financial sector approach” from the start of its existence.</td>
<td>2</td>
<td>Lack of clarity of CGTSI’s design and strategic approach has been exacerbated by RBI’s broader signals about SSI lending, which has confused CGTSI’s perception in the marketplace.</td>
<td>3</td>
<td>LDF has taken the “financial sector approach” from the start of its existence.</td>
<td>2</td>
</tr>
<tr>
<td><strong>7</strong> FOGAPE has a good understanding and strong empathy with market forces.</td>
<td>1</td>
<td>CGC has an understanding and empathy with market forces, equivalent to that of its partner banks.</td>
<td>2</td>
<td>There is some doubt whether CGTSI is sufficiently sympathetic to market forces and to the commercial realities of lending to the sector to enthuse banks to the degree required to meet its</td>
<td>2</td>
<td>LFP has an understanding and empathy with market forces.</td>
<td>2</td>
</tr>
</tbody>
</table>

Where 1 indicates a very good enabling factor while 4 indicates a very poor enabling factor.
<table>
<thead>
<tr>
<th>Lessons and Insights</th>
<th>FOGAPE (Chile)</th>
<th>CGC (Egypt)</th>
<th>CGTSI (India)</th>
<th>LFP (Poland)</th>
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<td>8</td>
<td>FOGAPE takes a long term approach emphasising institutional and financial stability.</td>
<td>CGC takes a long term approach emphasising institutional and financial stability. This has improved over the years, as new models for guaranteeing SME lending operations have been developed. There is some evidence of excessive bureaucracy, but an upcoming restructuring effort is expected to improve this.</td>
<td>CGTSI has been set up with a long term perspective with a total resource commitment of Rs 25 billion (USD 550 million) from the two trustees. This will reassure the market.</td>
<td>LDF has a long term approach emphasising institutional and financial stability. However, it has taken advantage of available subsidies for development agencies and CGS.</td>
</tr>
<tr>
<td>9</td>
<td>Continual training of commercial front-line bankers in how to use the CGS product has taken place. FOGAPE provided this more than the bankers themselves, at least initially.</td>
<td>CGC was the credit guarantee pioneer in the early 1990s, but this role has diminished as CGS become better known. Extensive transfer of appropriate SME lending technology to banks is no longer in evidence. Technology transfer is apparent in CGC’s microfinance activities.</td>
<td>CGTSI has a large and increasing training effort in using guarantees. Bank officers are trained through workshops, by identifying internal bank training leaders to channel material, and through multi-channel marketing and awareness campaigns which reach SSI associations as well as banks.</td>
<td>In the 1990s, when they were little understood, LFP served as the pioneer for credit guarantees in the Lublin region, however this role has diminished. There is no evidence of transfer of appropriate lending technology to banks currently.</td>
</tr>
<tr>
<td>10</td>
<td>Institutional arrangements allow banks a consultative and advisory role through representation on the consultative committee. This is seen as an example of tripartite cooperation between SME.</td>
<td>Non-shareholder banks do not have formal input into decision-making.</td>
<td>Elements of a participative approach are apparent in the Review Committee of representatives of five member banks which meets twice a year and can make recommendations, and the Disputes Review</td>
<td>Partner banks do not have a consultative role in LFP decision-making.</td>
</tr>
</tbody>
</table>
Lessons and Insights

<table>
<thead>
<tr>
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<th>LFP (Poland)</th>
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<tbody>
<tr>
<td>representatives, banks and FOGAPE.</td>
<td></td>
<td>Mechanism being set up under IBA auspices for member banks independent of CGTSI.</td>
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</table>

11 While there is ownership by bankers in the sense of enthusiasm for FOGAPE’s products and recognition that FOGAPE is working for their benefit, there is no actual ownership or participation in governance by lenders.

1 11 Institutional arrangements allow shareholder banks a directive role through their representation on the Board. However, shareholder banks are now the minority.

2 11 Up to now, there has been no official suggestion that the above elements could develop into “ownership” in the sense of direct participation by member banks in governance (currently only through the Chairman of the IBA).

3 11 The structure of LFP as a subsidiary company wholly owned by LDF does not allow partner banks a directive role.
Evidence of Financial Sector Deepening

Direct Deepening

56 The term “direct deepening” was used in the context of the case studies to refer to effects linked directly to the current use of credit guarantee products by banks. It is easier to identify this type of financial sector deepening and to link it to the activities of the CGS.

57 The case study revealed the following insights.

- Banks in most countries studied demonstrated interest in the CGS for a range of reasons, including commercial profit-seeking and a desire to comply with government policies. Those that are motivated by a desire to comply with government policies generally failed to move beyond small-scale use of credit guarantees. Those with commercial motives sometimes move quickly to direct non-guaranteed lending and sometimes not, depending on external factors such as economic conditions. For this reason, volume of credit guarantee transactions can be variable from year to year within the same bank.

- The number of banks using credit guarantees to address the SME sector increased through the life of all the case study CGS, which implied some direct financial sector deepening. In some cases, however, the CGS has failed to reach sufficient scale to enable it to have a significant impact on financial sector deepening. The primary factors that retarded achievement of sufficient scale included: conflicting signals on lending to the SME sector from governments and central banks; and competition from programmes that are not market driven and which crowd out market driven initiatives.

- Direct financial sector deepening was also indicated by:
  - falling average risk shares of guarantees in some CGS partner banks, with the banks taking more of the lending risk over time (Chile and Poland);
  - the tendency of some banks to rely to an increasing extent exclusively on the credit guarantee as security, which meant that SME loans were partially unsecured (Egypt);
  - an increase in the range of products available to SMEs by CGS partner banks in some countries (Chile and Poland);
  - institution by partner banks of dedicated SME lending departments and credit officers, specialised SME products, simplified procedures and targeted marketing for the SME sector (Chile and Poland); and
  - strong and increasing competition on both quality and cost of SME financial services in some markets (Poland).

- Banks generally cited the CGS as an important tool in their strategic approach to the SME sector and indicated that their use of CGS services had enabled them to extend the outreach of their commercial lending operations, in terms of borrowers who would not otherwise get access to funds or better
terms and/or greater access for existing customers. Most banks wanted to increase their use of the CGS in future. The willingness to move beyond guaranteed loans to non-guaranteed lending was variable, however. Some banks expressed the opinion that they would never be able fully to absorb the risk of lending to marginal SMEs and that this was more properly the function of the CGS. This implies a permanent role for CGS that runs contrary to the common view expressed by donors.

- The use of guarantee products to service SME borrowers had been mainstreamed within most banks and for a significant proportion of loan officers. Training of loan officers in the use of guarantee products was a priority for most CGS, however transfer of SME lending technology in the wider sense was not. In most cases banks indicated they were familiar with SME lending technology, and in some cases banks felt they had proprietary SME lending technology, and in almost all cases felt that the CGS would not be able to provide them with methodologies or techniques that they did not already possess.

**Indirect Deepening**

58 Indirect deepening refers to the broader effects on bank behaviour brought about by their experience of guarantee usage or their observation of other banks’ experience of guarantee usage. In general, the evidence for indirect deepening was scarce and circumstantial: causal links were difficult to identify.

59 The most successful CGS studied, FOGAPE in Chile, is providing risk information which bankers are beginning to use to argue for changes in their risk management approach to the SME sector as a whole.

60 Led by the successful take-up of CGS credit guarantee products in Chile, a similar product aimed at the next SME sub-segment upwards in terms of business size will be introduced shortly. While this is an action initiated by a government financial agency and not the banks, it could not be implemented without the cooperation of the banking sector and therefore could be seen as indirect financial sector deepening.

61 In some cases (notably in Chile and Poland), we noted diversification of SME-specific financial products by banks, in response to the growing importance of the SME sector and to competitors’ introduction of new SME lending products. This broadened the choice available to SMEs and therefore constituted financial sector deepening, but could not be directly attributed to the operations of the CGS.

62 Overall, the researchers felt that the study demonstrated that financial sector deepening has occurred in the case study countries and that it can reasonably be attributed in part to the operations of CGS.
Conclusion

63 The study demonstrated that that financial sector deepening has occurred in the case study countries and that it can reasonably be attributed in part to the operations of CGS. This was more apparent with respect to direct deepening: causal links were not clear enough to confidently identify instances of indirect deepening.

64 The case studies identified significant factors for success that were not included in the original Thesis. An amended Thesis is presented below.

65 “Credit guarantee schemes (CGS) are effective in promoting sustainable changes in lender behaviour, leading to financial sector deepening, in situations where certain specific factors for success pertain. The key “factors for success” (and, by corollary, the factors for failure) necessary for CGS to effectively promote financial sector deepening include those set out in Table 5. While it is difficult and to some extent subjective to prioritise these factors, we have attempted to do this by arranging the factors in an order that, in our opinion, represents their relative importance (most important factors first), separately for Macro and Micro factors.

Table 5: Revised Factors for Success
in rough order of importance

<table>
<thead>
<tr>
<th>Factor for Success</th>
<th>Factor for Failure</th>
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<tbody>
<tr>
<td><strong>Macro Factors</strong></td>
<td></td>
</tr>
<tr>
<td>1 an open, competitive banking environment wherein there are a number of independent banks, a majority of which are interested in expanding their client base, establishing niche markets, or protecting market position;</td>
<td>a thin banking sector that is controlled by a few powerful vested interests, in which banks are sufficiently profitable with their existing, limited clientele to support the financial and/or political ambitions of those controlling interests;</td>
</tr>
<tr>
<td>2 a dynamic and/or expanding business sector within which viable opportunities are available for exploitation by new entrants including MSMEs;</td>
<td>a thin business sector that is not under pressure to change or reform, in particular to become more inclusive;</td>
</tr>
<tr>
<td>3 a policy environment wherein initiatives are coordinated and reinforcing and other government or donor initiatives do not crowd out market-driven initiatives, in particular through provision of competing subsidised credit or other below-market financial products and services, including (but not limited to) credit guarantees;</td>
<td>a policy vacuum or a fragmented policy environment where clear signals are not conveyed about the importance of the SME sector and the means by which it is appropriate to promote and develop it, and where a multiplicity of competing or conflicting approaches can therefore exist at the same time;</td>
</tr>
<tr>
<td>4 a monetary and regulatory environment that is conducive to lending to SMES, in particular with sufficient liquidity and stable interest rates that allow for appropriate risk/return pricing;</td>
<td>restricted liquidity for SME lending and/or excessive interest rate risk that discourages opening up new markets;</td>
</tr>
<tr>
<td>5 a framework for business (political, policy,</td>
<td>endemic corruption and/or incompetence</td>
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### Conclusion

<table>
<thead>
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<th>Factor for Success</th>
<th>Factor for Failure</th>
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<tr>
<td>legal, regulatory and social) that, in its application as well as its theory, is supportive of enterprise in all its forms including MSMEs;</td>
<td>that distorts and/or restricts the operation of market forces and discourages MSMEs from entering the formal economy;</td>
</tr>
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<td>6 support from a competent agency (such as the Ministry of Finance, or more usefully the central bank and/or banking supervisory authority) that takes an imaginative, positive and well-informed interest in the SME sector and its financing problems and which works to enhance the enabling environment for SMEs;</td>
<td>interference from an ill-informed government agency that takes an ad-hoc approach to problems in the financial sector and uses the financial sector as a tool to address policy issues;</td>
</tr>
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<td>7 a credit bureau that provides effective and efficient access to credit information on SMEs that helps improve the ability of banks to assess risk of lending to SMEs.</td>
<td>no available credit information on SMEs or partial or unreliable information that does not help banks to assess risk.</td>
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**Micro Factors**

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<th>Factor for Success</th>
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<td>8 emphasis on promoting dynamism through fostering of competitive behaviour among participating lenders, including a high degree of transparency with respect to participating bank performance.</td>
<td>lack of transparency or competition; low expectations of the potential of partner lenders to effectively address the needs of the SME sector;</td>
</tr>
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<td>9 a “financial sector” approach to CGS design that focuses on the goal of achieving a permanent deepening of the financial sector;</td>
<td>a “social sector” approach that focuses exclusively on a short-term goal of pushing finance to the SME sector and the use of financial institutions as conduits for that purpose;</td>
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<td>10 an understanding of and empathy with market forces, particularly for providers of financial intermediation services;</td>
<td>an emphasis on the social obligation of lenders or compliance with laws, regulations or policies</td>
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<td>11 continual client (bank) focus and emphasis on innovation to deliver improved and expanded benefits, including provision of information to help banks assess the risk of lending to SMEs;</td>
<td>a focus solely on provision of increased numbers of guarantees without a broader objective of financial deepening;</td>
</tr>
<tr>
<td>12 a long-term approach that emphasises institutional and financial sustainability, with objectives directly related to financial sector deepening, even if project interventions are short or medium term in duration;</td>
<td>a project approach that focuses on short-term objectives that are limited to the period of the project intervention, rather than directly related to long-term financial sector deepening;</td>
</tr>
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<td>13 a participative approach that achieves a balanced partnership between donors, CGS and lenders for achievement of agreed objectives;</td>
<td>a paternalistic approach that imposes a CGS project on reluctant lenders who do not understand or do not agree with the stated objectives;</td>
</tr>
<tr>
<td>14 “ownership” (in the sense of active interest and participation) by lenders of the CGS stemming from clear and significant benefits to lenders in terms of assistance to open up new markets for profitable commercial exploitation;</td>
<td>coercion of lenders through a “carrot” (non-transparent benefits unrelated to financial sector deepening) and/or “stick” (pressure from political or regulatory authorities) approach;</td>
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<td>15 during its establishment stage, an influential “champion” (or champions) within the lender(s) who actively promotes the CGS for appropriate commercial reasons;</td>
<td>lack of support or lack of understanding of the commercial logic of the CGS within the lender(s);</td>
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<td>16 extensive transfer of appropriate lending</td>
<td>reliance on targets for achievement of</td>
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### Conclusion

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<th>Factor for Success</th>
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<td>“technology” in terms of policies, procedures, methodologies and systems through carefully focused technical assistance;</td>
<td>project lending objectives without regard for the ongoing sustainability of institutional processes;</td>
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66 “Taking a financial sector approach” means taking as a primary objective the development of the financial sector, as opposed to the development of the SME sector. “Development” in the context of this study means financial sector deepening – extending profitable operations of commercial banks into otherwise poorly-served niche markets (in this case, primarily the marginal SME sector).

67 Achieving financial sector deepening is achieved through removing bottlenecks and barriers, lowering information costs, education and demonstration that actual risk is lower than perceived risk, and (potentially) sharing risk for marginal transactions through CGS mechanisms. A key objective of a CGS should be to enable each bank to find its own way of profitably using the CGS mechanism to extend its services into marginal markets. This will depend to some extent on the nature of each bank’s operations. This implies a light touch by the CGS in terms of targeting so that, while overall additionality is ensured, a broader view of banking sector development is maintained.

68 The same market discipline needs to be applied to the CGS, so that it uses its resources efficiently while responding to the demands of its (financial sector) market for competitive products. CGS should therefore be financially self-sustaining.

69 It is insufficient for development-orientated agencies, most of which are government or donor funded, to point to increased usage by lenders of credit guarantees as justification for their continued existence. In other words, provision of credit guarantees, even at steadily increasing levels, is an inadequate objective for a CGS. The proper objective for a CGS is to promote financial sector deepening. Continually searching for new ways to influence lenders to expand their involvement with the target clients is required, even if this means increased risk exposure for the CGS through the introduction of new products and targeting of new SME sub-sector client groups.

70 Credit information remains key to assessing and managing risk. The existence of a credit bureau that provides information on SME-scale loans is an essential part of the enabling environment for the SME sector. Through their operations, through the use of now-inexpensive computerised monitoring systems, CGS have the opportunity to build a significant body of information on SME risks and on borrowers’ credit history. This is a significant difference from the CGS of decades ago. This information would constitute a significant benefit for participating banks, once the CGS has built up to a sufficient scale of operations. This aspect, and its usefulness in promoting lending to the SME sector, has not been recognised by all the CGS studied.

71 Significant impact on financial sector deepening cannot be expected from a one-dimensional approach. The use of CGS on its own cannot achieve significant financial sector deepening without support from government and donors to ensure that messages are consistent, initiatives are coordinated, and poorly conceived programmes that crowd out more market-driven initiatives are terminated.
The Role of CGS in Financial Sector Development

72 The Thesis developed for this study implicitly treats CGS as one of the tools in the financial sector development “toolbox”, and tries to map out the circumstances under which use of CGS is appropriate, as well as the circumstances under which it is not appropriate. In general, the conditions where CGS are likely to be effective in promoting financial sector deepening are those where the basic conditions for financial sector development are already in place. **CGS serve as accelerators, not drivers, of financial sector deepening. In other words, CGS are not a necessary condition for financial sector deepening. In fact, where the need for financial sector deepening is greatest, CGS are least likely to be successful in promoting that deepening.** This may go some way towards explaining why CGS are generally dismissed by macro-economists, policy thinkers and others concerned with putting in place the fundamental requirements of a healthy financial sector.

73 However, it may be that the role of an accelerator is one that can still be useful. The financial sectors of developed countries still have problems with inclusion16/ (albeit to a much different degree than most developing countries), and the current degree of inclusion has taken decades to achieve. To take a similar period to achieve similar rates of inclusion in developing countries would be unacceptable.

74 Questions about the sequencing of financial sector reforms can be answered, in general terms, as a result of the insights achieved from this study. In our view, CGS should be seen as one of the final steps toward achieving significant financial sector deepening, once all other significant factors have already been put into place. CGS provides a means to accelerate the downscaling of banks into previously unbanked markets, but is unable to overcome serious deficiencies in the structure of financial markets to achieve financial sector deepening.

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16/ For example, a study by the Financial Services Authority found that 7 percent of UK residents do not access basic banking services, including a bank account (FSA, 2000).
Appendix A1

A1 Terms of Reference

1. Project Title

Evaluation of Impact of Guarantee Schemes on Financial Sector Deepening

2. Background

DFID’s Financial Sector Team is undertaking a study to better understand the triggers and incentives that will encourage formal financial institutions to deepen outreach to poorer, unbanked or underserved segments of the market. Part of this work will look at the mechanisms that can be used by donor organisations to encourage the process of financial sector deepening.

In 1997, DFID commissioned a substantial piece of work on the role of credit guarantees to formal financial institutions in the provision of small business lending. This resulted in the undertaking of a significant survey of guarantee schemes around the world and the provision of advice, guidelines and lesson learning on how such mechanisms can be best used for the effective delivery of MSE/SME lending. Despite much criticism of such schemes over the years, the reports provided positive feedback on the long-term potential of loan guarantee schemes if they are well designed and managed.

DFID is currently operating guarantee schemes for SME/MSE lending in Kenya, Zimbabwe and China. Such schemes are also used by a plethora of other donor agencies/NGOs including USAID, ACCION, FUNDES, SECO (State Secretariat for Economic Affairs, Switzerland), EBRD and AFD.

Much of the work undertaken to assess the impact of guarantee schemes has concentrated on the borrower (i.e. the small business owner) and the impact on the business itself. Work related to the guarantor and lender has been largely limited to (a) the extent to which additional (as opposed to substituted) lending took place within the context of the guarantee itself, and (b) the mechanics, design and management of guarantee schemes. Little emphasis has been placed on the ultimate, medium to long-term impacts on the lending institution itself – it’s attitude to new markets and ability to serve them. Despite the difficulties of examining such impact, it is in itself an important analysis to undertake, and has far reaching implications in increasing our understanding of whether such mechanisms can truly contribute to sustainable changes within the financial sector, particularly in terms of institutional behavioural changes that ultimately result in financial deepening.

3. Overall Objectives

To undertake a short study to evaluate the impact of guarantee schemes on lender behaviour and the operation of financial markets. More specifically, the work will cover an assessment of whether the introduction of guarantee schemes has resulted in sustainable changes in actual lending behaviour towards those markets to which the guarantee introduced the lender, together with the wider impact this may have had on the financial sector as a whole (i.e. through a demonstration effect).
study should also attempt to disaggregate the extent to which sustainable changes in lender behaviour were as a result of the guarantee itself, or due to a combination of alternative exogenous factors.

The results of this work will feed into a number of areas:

- To inform the work of other interested donors, particularly USAID, which is currently undertaking research to identify how to better use guarantees to increase MFI access to commercial financing.

- The broader work on incentives and triggers for formal financial institutions to deepen outreach being undertaken within DFID’s Financial Sector Team. This work will contribute to broader development thinking on the use of guarantees as a mechanism to promote financial sector deepening.

4. Scope of Work

Where possible the work should draw on the consultants own specific knowledge of guarantee schemes, different financial sector markets, financial sector institutions and secondary literature. Resources for country travel for this study are limited, but will be permitted if identified country specific situations are likely to bring out particularly interesting lessons which relate to the work in hand. Other methods, such as surveys of financial institutions should also be explored.

The work should aim to answer the following questions.

- Whether guarantee programmes have resulted in increased lending to the targeted sector after the guarantee programme was withdrawn (or did it allow graduation of clients to non-guarantee based lending if the guarantee is still in place).

- To what extent can any identified new ‘non-guarantee’ based lending to the MSE/SME sector by the financial institution in question be attributed to the guarantee mechanism itself.

- To what extent did other factors play a part in the commencement of any ‘non-guarantee’ based lending to the sector? What were these factors and which ones were more prominent in terms of their influencing role?

- Did the guarantee programme / lending to the SME/MSE sector result in changes of behaviour within the financial sector as a whole.
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*Appendix A2*

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A3 Structured Questionnaires

Introduction

The UK Department for International Development (DFID) wants to investigate the circumstances and factors determining whether Credit Guarantee Schemes (CGS) contribute to financial sector deepening: that is how, and to what extent, do banks change their lending activity with the SME sector as a result of the CGS. The results will be disseminated to deepen the understanding of donors and policy makers in SME finance. This is not a broad study of the design or implementation of an individual CGS, but is focused on this particular issue.

The method to be used in the study is as follows:

• obtain from the CGS, through e-mail or other means, basic data on history, design, rules and statistics of activity and performance (annual reports or similar) to supplement and fill in gaps in the data we already have;

• conduct a structured personal interview (with questions circulated in advance) with CGS managers at the beginning of the case study, and a follow-up on key issues identified toward the end of case study;

• select 3 to 5 participating banks and carry out structured personal interviews with the manager responsible for the bank’s SME lending, supported possibly by a full-time SME lending officer (questions, issues and requests for data, circulated in advance). Answers can if required be anonymous so that they are not attributable to a specific bank;

• supplementary personal interviews with other appropriate people such as SME finance academics, central bank SME officer, and possibly others;

• desk research on the context of the SME sector and its financing, possibly with help of references or experts suggested by the CGS.

We would like to have copies of available data analysing recent CGS usage, including the value and volume of transactions, by individual banks, so that we can understand the degree of participation in the CGS by the participants in the study.

We would like to enlist the help of the CGS in obtaining the co-operation of the selected participating banks. In particular, we would like the CGS to contact the selected banks to advise them that it endorses this study and asking the banks to take part in interviews.

A draft of the interview questions is attached. The questions are divided into those that are directed at the CGS management and those that are directed at the participating banks.
Basic Data on the CGS

Scheme History and Details

- Basic information – date started, names and shares of investors, organisational and financial history.
- Rules of the scheme – target market, risk share, guarantee size limits, etc.
- Reforms (if any) to scheme organisation / finances / rules, reasons for reforms, results.
- Number and amount of guarantees written and amount of loans supported (by lender by year), amount of guarantees and loans outstanding, number and amount of calls, amounts recovered etc.
Questionnaire

Questions for CGS Management

Design Philosophy and Approach

• Does CGS management see participating banks or SME borrowers as its prime customers/targets?

• Do operational goals/or targets of the CGS include bank behaviour or activity? What are they? Quantitative and qualitative? For example:
  • quantitative, such as increased penetration within bank’s portfolio of certain target groups of businesses as borrowers;
  • qualitative: changes such as changes in SME lending practice.

• Do these targets extend to banks’ non-guaranteed SME lending behaviour? Are there specific success measures or targets for each bank?

• Do you require detailed reporting on CGS activity to support this strategic approach by participating banks? Is this an administrative burden for them?

• Why did the banks agree to participate? Why do they continue to participate? What are their intentions for future participation? The underlying question is: Is the CGS seen primarily as a commercial benefit that helps deepen existing/open up new markets, or as a donor or government-driven programme imposed upon them perhaps at a cost?

• Are the benefits derived from the CGS by the participating banks clear to them? Are they significant?

• What mechanism is there for feedback from participating banks to the operation, commercial terms and product range of the CGS, and vice versa?

• What are the constraints on expanding the guarantee operation, both in terms of increasing the importance placed on it/usage of it/commercial benefits gained from it by current participators, and in terms of encouraging more banks to participate? Demand side and supply side factors (for example, budget for costs of subsidy, competitiveness of banking environment, regulatory issues) should be considered separately and an overall judgement made as to what are the key issues.

• What lessons have been learned during the lifetime of the scheme about the ways to improve operating relationship including commercial aspects between the banks and the CGS?

• Is the scheme moving towards sustainability? What degree of on-going subsidy is needed? What is the relationship between sustainability and financial deepening?

• Has securitisation of guaranteed loans been considered, as a way of enhancing the value of the scheme to banks?
Potential for Impact

- What proportion of banks addressing the SME sector are included within the CGS? What are the notable exceptions and why?
- Do most branches and credit officers within the banks handle CGS loans?
- What factors explain big variations between the actual versus expected amount of business done by particular banks?
- Has the CGS stimulated SME lending, for example through allowing new market segments to be opened up? Have most loans been to the target groups for example new customers of the bank, first time borrowers, start-up businesses? Does this include some non-guaranteed lending? Is there evidence for this?

Impact on Participating Banks

- Has the institutional attitude to the relative risk and return of lending to the SME sector changed significantly as a result of the CGS? What evidence is there of this? Is this attitude prevalent and consistent at all levels of management and line staff?
- Has overall lending to SME sector by participating banks increased or decreased following their participation in CGS? How much of this can be attributed to the CGS, and how much to other factors?
- Have the terms and conditions of lending to the SME sector changed since the start of the CGS (for example, have maturities increased, have maximum loan amounts increased, have collateral requirements changed)?
- Has the CGS contributed to learning or transfer of technology in SME lending in the broad sense (policies, procedures, methodologies and practices)? Are loan officers being trained in this lending technology?

Impact on the Financial and SME Sectors

- Has the CG scheme stimulated competition in SME lending, e.g. have other lenders started or increased lending to the sector since the CGS started? Has the CGS allowed niche strategies attacking the SME market by some players? What is the evidence for this?
- Has lending volume to SMEs grown at a greater rate than the growth in GDP attributable to SMEs?
- Has the SME sector grown at a faster rate after the CGS than before? (has the birth rate of new firms increased?).
Appendix A3

Do Credit Guarantees Lead to Improved Access to Financial Services? / February 2005

Impact on the Enabling Environment

- Have default rates in SME lending within the CGS and outside it increased during the scheme’s life/been higher than default rates in other sectors?

- Has the political, policy, legal and/or regulatory environment become more conducive to SME activity since the CGS started? To what extent do CGS managers attribute this change to the activities of the CGS and its participating banks?

- On the other hand, has the CGS prevented or delayed other developments which would have been conducive to SME banking as a whole?

Requirements of the Enabling Environment

- What features of the banking environment (policy, legal, competition, regulations) are necessary for a credit guarantee scheme to have a good chance of influencing banks?

SME and SME finance context. References or signposting to other sources would be much appreciated.

Any available statistics on SME population by size and sector, on numbers of start-ups by sector, on penetration of SME sector by banks. Surveys and reports on SME finance to show picture of main suppliers, behaviour in market place, and patterns of demand, as well as bank finance in context of other SME finance sources.
Appendix A3

Questions for Participating Banks

**Strategic Approach**

- Which of these two statements is more accurate?
  - Guaranted loans are, or could lead to, a profitable line of business for the bank, and form part of our commercial strategy to the SME sector.
  - Guaranted loans are in principle not profitable, but something we do to assist the government's development policy.
- When did the bank join the CGS? Who initiated that action? Was it done in response to a request from government or the CGS, or because of a desire to expand into the target sector?
- Why does bank continue to participate? Who drives the CGS activity within the bank? What are bank's intentions for future participation?
- Are the benefits derived from the CGS clear and significant? Can they be articulated and/or quantified?
- Is lending to SMEs, including CGS supported lending, seen as a profitable / core business activity?
- Is the target market one that is seen as a permanent part of the bank’s portfolio or temporary to help government with its agenda / take advantage of a temporary financial advantage?
- Has the CGS helped the bank to service its customers better?
- Does the bank have different (for example, more stringent) rules for eligibility than the CGS itself?
- Have there been any reforms to the CGS since it started? Have these been generally beneficial?
- Bank's suggestion for improvements:
  - What factors/changes would encourage (or would have encouraged) the bank to make more use of the CG facility/view it as more commercially attractive? for example: operational issues: (simpler administrative procedures, quicker payment of claims), change in terms of guarantee (freedom to charge higher interest rates, take personal guarantees from borrower as secondary security).
  - Would you have any regrets if the CGS were discontinued?

**Potential for Impact**

- Duration and volume of activity:
  - Number and value of guarantees written and amount of loans supported by guarantee in each of the last 5 years? (analysis by size of loan/firm
and sector, including number and amount of defaults, amounts recovered).

- Have the targets of the bank for the CGS been achieved?

- **Borrower profile (guaranteed loans):**
  
  - Analysis of number and amount of lending by category of borrower. For example, first-time borrowers, entirely new customers to bank, start-up businesses. Categories will overlap of course.

- **Relation to other SME lending in same categories:**
  
  - Number and amount of total lending in the same categories (for example, term loans of the same maturity range, for the same purpose) to SMEs in these years (analysed by size loan, size of firm and sector, if available).

- **Borrower profile non-guaranteed loans:**
  
  - How does the borrower profile for non-guaranteed loans differ from that for guaranteed loans? Analysis of number and value by category of borrower. For example, first-time borrowers, entirely new customers to bank, start-up businesses. Categories will overlap of course.

- **Penetration of guaranteed loans in bank’s market operation:**
  
  - Number and proportion of the bank’s branches handling guaranteed loans?
  
  - Number and proportion of the bank’s SME lending officers handling guaranteed loans?

**Impact on the Bank**

- Has the bank’s policy or practice on SME lending, including that without guarantees, changed as a result of exposure to guaranteed loans? Can you provide evidence to support this? For example:
  
  - Is the bank more willing to lend, without a guarantee, to start-ups, women entrepreneurs, or other first-time borrowers, than it was?
  
  - Is the bank more willing to lend with lower collateral ratios, or for longer maturities, than it was?
  
  - Is the bank making non-guaranteed loans in different sectors previously only accessible with guarantees?

- Is this lending activity contributing to the profits of the bank?

- Has overall lending to the SME sector by the bank increased or decreased following its participation in CGS? How much of this can be attributed to the CGS, and how much to other factors?
Appendix A3

Have the terms and conditions of lending to the SME sector changed since the start of the CGS (for example, have maturities increased, have maximum loan amounts increased, have collateral requirements changed)?

Have default rates in CGS lending / in SME lending increased over the duration of the scheme? have default rates in CGS lending / SME lending been higher than default rates in other sectors?

Has the bank learned anything from its participation in the CGS, in terms of transfer of SME lending technology in the broad sense (policies, procedures, methodologies and practices)?

Are guaranteed loans included in lending officer training?

Do lending officers have a positive view of the CGS?

Are numbers of guaranteed loans (or another measure on guaranteed loans) included in lending officer performance targets?

Does the experience of making guaranteed loans contribute positively to lending officer professional development?

Impact on the Financial Sector

Has the CGS stimulated competition in SME lending, for example through encouraging niche strategies by some players?

Has it affected the market for SME lending in any other way?

Impact on the Enabling Environment

Has the political, policy, legal and/or regulatory environment become more conducive to SME activity since the CGS started? To what extent does the bank attribute this change to the activities of the CGS and its participating banks?

Has the CGS had any negative effects in any way on the development of SME banking? For example making borrowers less willing to repay loans, or allowing the bank to limit its exposure to marginal groups through linking this to the availability of guarantee capacity.

SME and SME finance context. References or signposting to other sources would be much appreciated.

Any available statistics on SME population by size and sector, on numbers of start-ups by sector, on penetration of SME sector by banks. Surveys and reports on SME finance to show picture of main suppliers, behaviour in market place, and patterns of demand, as well as bank finance in context of other SME finance sources.
## Evaluation of the Impact of Credit Guarantee Schemes on Financial Sector Deepening

### Annotated Long-list of Credit Guarantee Schemes: Candidates for Case Study

<table>
<thead>
<tr>
<th>CGS Name</th>
<th>Country</th>
<th>Year Established</th>
<th>Scale</th>
<th>Participating Banks</th>
<th>No. Participating Banks</th>
<th>International Donor funding / Other sources of capital</th>
<th>Target Group</th>
<th>Size of Fund</th>
<th>Guarantee</th>
<th>Comment</th>
<th>WWW</th>
</tr>
</thead>
<tbody>
<tr>
<td>GARANTIZAR (mutual guarantee society) (the 1st to operate in Arg and the market leader)</td>
<td>Argentina</td>
<td>1997</td>
<td>First 2 years: 120 transactions USD15m. Expanding range of markets and services. 5 funds</td>
<td>At least 4</td>
<td>At least 4</td>
<td>Founded under the auspices of all the government bodies supporting SMEs</td>
<td>SMEs, multi-sectoral and gtee type incl. technical, multi-purpose, incl. education and factoring</td>
<td>Overall resources: USD35m</td>
<td>Up to 100%</td>
<td>Request Fee 0.5% ; Comm. variable Max Amt: USD350k Max Term: 5 years</td>
<td><a href="http://www.garantizar.com.ar">www.garantizar.com.ar</a></td>
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<tr>
<td>FOGABA (Guarantees Fund of the Province of Buenos Aires)</td>
<td>Argentina</td>
<td>1995</td>
<td>Four years 141 operations for total of USD 14 million</td>
<td>Agreements in place with 12</td>
<td>12</td>
<td>Company 85% state owned + chambers, business &amp; SMEs</td>
<td>MSMEs in BA province</td>
<td>USD 27m</td>
<td>Up to 75 %; &gt;USD100k borrower buys share in gtee fund. Comm.: 2% on average, with 1% in advance</td>
<td>Delinquency rate: 3% but low volume, large transactions</td>
<td><a href="http://www.fogaba.com.ar">http://www.fogaba.com.ar</a></td>
</tr>
<tr>
<td>SEBRAE Fondo de Aval (Brazilian Small Enterprise Assistance Service - Guarantee Fund)</td>
<td>Brazil</td>
<td>1996</td>
<td>8,325 operations USD75m in 5 yrs to 2001</td>
<td>Approx 2/3 from workers protection fund; 1/3 state bank, 3% reg. gov.</td>
<td>14 in total, wide range</td>
<td>1/3 state bank, 3% reg. gov.</td>
<td>Micro and small businesses</td>
<td>USD 45.5m by 2000. Multiple 1996 to 10 times</td>
<td>40-90%, Max loan: USD 40k Term: 24-90 months. Comm. 2-6% depending on term</td>
<td>Criticised as &quot;supply driven&quot; 2003, low volume for size of economy</td>
<td><a href="http://www.sebrae.com.br">www.sebrae.com.br</a></td>
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<tr>
<td>Capeo</td>
<td>Burkina Faso</td>
<td>1992</td>
<td>no data</td>
<td>no data</td>
<td>no data</td>
<td>CIDA financed; Executed by Development International Desjardins</td>
<td>SMEs 5-50 employees most sectors inc. agriculture</td>
<td>Approx USD 50m</td>
<td>50%</td>
<td>Not enough data</td>
<td><a href="http://www.spid.com/capeo/fondation.html">http://www.spid.com/capeo/fondation.html</a></td>
</tr>
<tr>
<td>FOGAPE BANESTADO</td>
<td>Chile</td>
<td>1991 but reformed 1999</td>
<td>Explosive growth 1998-2002: 28,000 operations in 2002, USD 215m</td>
<td>17 banks compete for gtee capacity in quarterly auctions run by FOGAPE</td>
<td>17 banks compete for gtee capacity in quarterly auctions run by FOGAPE</td>
<td>100% gov't, managed by MFI sub of state bank, BANESTADO</td>
<td>Agricultural firms up to USD420K Non-ag up to USD750K</td>
<td>Approx USD 50m</td>
<td>Up to 80% Max gtee USD 90k Comm. 1-2% p.a. on gteeed amt. Term: up to 10 years.</td>
<td>First global instance of capital enhancement gtee innovative commercial design seems to be working. Interesting</td>
<td></td>
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<tr>
<td>CGS Name</td>
<td>Country</td>
<td>Year Established</td>
<td>Scale</td>
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<tr>
<td>CORFO (Programa de Garantias de la Coboracion de fomento de la produccion)</td>
<td>Chile</td>
<td>1991</td>
<td>In 1999, approved USD11m in guarantees. USD 11m in active guarantees.</td>
<td>51</td>
<td>State org, direct budget allocation. IDB support for med and long term financing, and pilot SME programme</td>
<td>2 new SME programmes since Nov 2002: investment projects; exporter SMEs</td>
<td>Can guarantee up to a total of USD89m.</td>
<td>30-60% Max loan USD1.8m Comm. 1-2% one-off</td>
<td>Unusual &amp; innovative products works at w/sale level e.g subordinated bond g'tees, but direct SME impact unclear. Possibly too new <a href="http://www.corfo.cl">www.corfo.cl</a></td>
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<tr>
<td>China Economic Technological Investment and Guarantee Corporation Ltd (I&amp;G)</td>
<td>China</td>
<td>1995; Shanghai Branch 1999</td>
<td>15,675 firms with o/s g'tees; Shanghai branch first 18 mths 2000 operations.</td>
<td>Shanghai branch: &gt;10</td>
<td>I&amp;G: Government organisation directed and administered by a council of public institutions. Shanghai branch: local gov't funds only, local gov't directed</td>
<td>SMEs</td>
<td>SMFB allocated nearly USD 50m in 1999</td>
<td>80 to 90% in 1999; Fees 0.8-1.2 % p.a.</td>
<td>Rather heavily managed by public sector</td>
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<tr>
<td>Xingzhong Guarantee &amp; Leasing Co. Ltd (XZGLC)</td>
<td>Shanghai</td>
<td>Mar 2001</td>
<td>first 8 mths USD 10m loans, 20 customers</td>
<td></td>
<td>Private. Currently considered to be a non-bank and non-financial institution</td>
<td>SMEs. ST working capital loans, counter-g'teed (same as public g'tee funds).</td>
<td>Total equity capital contributed by 4 private investors is Y80 million (by Jan 2002)</td>
<td>Price higher than public g'tee funds</td>
<td>Interesting experiment, but may not have survived and only local impact</td>
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<td>Sistema Nacional de Garantías, S.A. comprising the National Guarantees Fund (FNG, S.A.) and 12 regional funds**</td>
<td>Colombia</td>
<td>1995</td>
<td>Cumulative to 2001: 15,000 enterprises; USD25m o/s g'tees. 5,329 operations Jan-May 2002 USD 113m credit mobilised</td>
<td>60 financial institutions</td>
<td>Focuses on credit guarantees for micro and SMEs; credit limit of 108 legal monthly minimum wages</td>
<td>Public</td>
<td>Fund size: USD19m. Capital subscribed and paid up: USD53m</td>
<td>Up to 70%. Comm. 1.05-3.05% Max g’tee USD320k. Term: up to 5 years. ** Evolved from success of reform of prev. FNG system. Long experience makes it a good candidate <a href="http://www.fng.gov.co">http://www.fng.gov.co</a></td>
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<td>FONAGA (National Guarantees Fund)</td>
<td>Costa Rica</td>
<td>1996</td>
<td>Not implemented because of delays in capitalisation from FODESAF (Fondo de Desarrollo Social ay Asociaciones Familiares) in 1991/2.</td>
<td>no data</td>
<td>Programme originated from a surplus generated by the FODESAF</td>
<td>SMEs and small agricultural producers</td>
<td>no data</td>
<td>50% Max loan USD35k Comm. 2%</td>
<td>Sadly nothing to look at.</td>
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<td>CGS Name</td>
<td>Country</td>
<td>Year Established</td>
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<tr>
<td>Czech-Moravian Guarantee and Development Bank</td>
<td>Czech Republic</td>
<td>1992</td>
<td>6 regional offices; supports inter alia a guarantee programme of EUR 81m (2002) 2,400 g'tees o/s</td>
<td>no data</td>
<td>joint stock company; 72% capital participation by state; 28% by commercial banks</td>
<td>SMEs - All sectors. Inc. technical g'tees, and subsidised g'tees.</td>
<td>USD60 m approx</td>
<td>USD100k or USD100 over 3 yrs. Investment projects: up to 70% g'tee on max USD670k</td>
<td>Low volume, not much drive in programme</td>
<td><a href="http://www.cmzrb.cz/cmzrb_be.asp">http://www.cmzrb.cz/cmzrb_be.asp</a></td>
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<tr>
<td>Garantias del Ecuador (Formerly Corporation de)</td>
<td>Ecuador</td>
<td>1991</td>
<td>Gone into liquidation 12/08/2000.</td>
<td>no data</td>
<td>Was 1% donor</td>
<td>Micro and small businesses</td>
<td>Was 0.36m USD by 1994</td>
<td>no data</td>
<td>No longer exists</td>
<td>Institution platform well-established carrying large volume, spread of targets, low default suggests good mglt</td>
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<tr>
<td>Credit Guarantee Corporation for Small Scale Enterprises</td>
<td>Egypt</td>
<td>1989</td>
<td>1st 9 yrs, 11,000 g'tees USD100m. 2003: 20,400 g'tees USD 95m includes micro programme</td>
<td>no data</td>
<td>Owned by national + 8 local banks + ins co. Most capital from donors, USAID and Italian</td>
<td>SMEs and healthcare firms with max funds of USD 2m</td>
<td>Approx USD 100m in all</td>
<td>50%</td>
<td></td>
<td>Institutional platform well-established carrying large volume, spread of targets, low default suggests good mglt</td>
<td><a href="http://www.cg.org.ee">www.cg.org.ee</a></td>
</tr>
<tr>
<td>PROGRA</td>
<td>El Salvador</td>
<td>1992. Reformed in 2000, in transition 2000-2002</td>
<td>APE 1st 7 yrs 35,000 g'tees USD100m, then decline. ARA 1999 10,000 g'tees o/s USD10m</td>
<td>8 + other FIs</td>
<td>Established with resources from USAID and Banco Central de Reservas El Salvador. New programmes under Banco de Inversiones</td>
<td>APE: SMEs all sectors. Special scheme transport co.s ARA: agricultural enterprises</td>
<td>Initial funds USD 17m &amp; 22m Ag.</td>
<td>30-90% Comm. 4% p.a. 2% Ag. Max g'tee USD57k, 115k Ag. Term: 1 yr renewable</td>
<td>Complex organisational change not likely to have settled. Trying for mutual, long term horizon</td>
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<tr>
<td>FUSAID PGPP programme (Programa para Garantizar Portfolio de Prestamos)</td>
<td>El Salvador</td>
<td>1996</td>
<td>no data</td>
<td>no data</td>
<td>100% USAID fund (HQ in Washington with local office in El Salvador)</td>
<td>MSMEs and MFIs</td>
<td>no data</td>
<td>50-70% Comm. 0.5%&lt;&lt; 2% p.a. Max loan USD150k for MSMEs &amp; USD500k for MFIs</td>
<td>Interesting but not much data. Also externally mgd so not capacity bldg.</td>
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<tr>
<td>FONAPROVI running 2 g'tee funds FONGAC &amp; FONGAC-PACTA</td>
<td>Honduras</td>
<td>1997</td>
<td>no data</td>
<td>no data</td>
<td>FONAPROVI: National and International (Taiwan, US, EU)</td>
<td>Agriculture, housing and access to land</td>
<td>Initial funds USD 91m</td>
<td>land access up to 30% of loan</td>
<td>Not much data and not SME oriented</td>
<td><a href="http://www.fonaprovii.hn">http://www.fonaprovii.hn</a></td>
<td></td>
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<tr>
<td>Credit Guarantee Plc</td>
<td>Hungary</td>
<td>1992</td>
<td>8,500 g'tees EUR458m in 2002. 0's EUR502m</td>
<td>26 + savings coops</td>
<td>51% govt', rest banks.</td>
<td>SMEs &lt;250 employees and &lt;USD13m f/o of all sectors, mainly urban.</td>
<td>EUR 83.3 m 2002 leverage approx. 6x</td>
<td>Up to 90% fo loans under USD 32k, 80% to max USD1.3m Comm. 1%+2-3% p.a.</td>
<td>Well established, high volume, linked into commercial banking. Should expect deepening</td>
<td></td>
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<tr>
<td>Loan Guarantee Scheme (START) of HFEP</td>
<td>Hungary</td>
<td>1992</td>
<td>No longer active. Live risk capital of USD2.5m in Sept 1995.</td>
<td>about 8</td>
<td>100% government funded but may have had later German donor support.</td>
<td>Initially SME start-up; later SMEs &lt; 4 yrs.</td>
<td>up to 80; 4% Comm. Max g'tee EUR125k</td>
<td></td>
<td>Probably moribund</td>
<td><a href="http://www.mva.hu/">http://www.mva.hu/</a></td>
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<tr>
<td>CGS Name</td>
<td>Country</td>
<td>Year Established</td>
<td>Scale</td>
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<tr>
<td>Rural Credit Guarantee Foundation (AVHGA)</td>
<td>Hungary</td>
<td>1991</td>
<td>2002: 13,000 o/s g’tees</td>
<td>129 savings banks + others</td>
<td>Started with EU PHARE funds (EUR 10m) and EUR 11m of funds from government and 5 banks. Owned 90% by the Ministry of Agriculture with 7 banks owning the remaining 10%</td>
<td>SMEs for loans for agricultural and rural development projects.</td>
<td>EU 57m at end 2002;</td>
<td>Up to 80% Comm 0.25% to 0.75% p.a depending on term. Average g’tee EUR34k duration 4.4 years</td>
<td>Big active scheme, but agriculture focused</td>
<td></td>
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<tr>
<td>YCO (Youth Charitable Organisation) loan guarantee scheme</td>
<td>India</td>
<td>1991</td>
<td>no data</td>
<td>Mainly 2 Indian housing finance institutions (HUDCO and HDIFC); also Canara and Baroda banks</td>
<td>Set up by Homeless International; Co-funding ODA/DFID (main) plus UK Housing associations, on an interest free deposit basis, and from the European Community</td>
<td>g’tees to enable groups to access credit from local FIs to create self-managed group housing solutions</td>
<td>GBP 600k</td>
<td>40%</td>
<td>Off-target though interesting use of g’tee instrument</td>
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<td>Credit Guarantee Trust or Small Industries (CGTSI)</td>
<td>India</td>
<td>2000</td>
<td>14,330 projects at April 2004, USD36m g’teed o/s'</td>
<td>35 public &amp; priv banks + reg. rural banks and other FIs are members. 22 MUs have used g’teed</td>
<td>Trust fund: government and SIDBI 4:1 ratio</td>
<td>SSIs in manufacturing or IT-related industry extended to more service sectors</td>
<td>Set up with USD28m now USD140m, 5 yr plan for USD550m</td>
<td>up to 75% Max g’tee USD40k</td>
<td>Technically innovative (on-line only); admit disappointment with overall take-up to date; active mgt, learning and adapting.</td>
<td><a href="http://www.creditguarantee.org.in">http://www.creditguarantee.org.in</a></td>
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<td>PT. Penjamin Kredit Pengusaha Indonesia</td>
<td>Indonesia</td>
<td>1995</td>
<td>existing in 2002 but no data</td>
<td>no data</td>
<td>private guarantee corporation. 70% participating banks; 30 percent others.</td>
<td>focus on university educated entrepreneurs running larger non-traditional SMEs</td>
<td>USD108.18m (by 1997, ILO).</td>
<td>max 70%</td>
<td>Aims at no subsidy &amp; using commercial re-insurance to offload some risk. Would be interesting if data accessible, but small in country context</td>
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<td>Perum Pengembangan Keuangan Koperasi (Perum PKK)</td>
<td>Indonesia</td>
<td>1981</td>
<td>1.43m SME beneficiaries; USD 147.5m guaranteed by 2001</td>
<td>10 national banks (1997), mainly BRI, Bukopin co-op bank and 27 provincial dev banks.</td>
<td>Originally cooperatives; now (since 1998) also formal SMEs in general (of all sizes and types).</td>
<td>no data</td>
<td>50-90%; Comm. 1.5-6% depending on term. max 8 yrs</td>
<td>Very large scale, methodologically intractable</td>
<td><a href="http://www.pkk.co.id">www.pkk.co.id</a></td>
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<td>Jordan Loan Guarantee Corporation (JLGC)</td>
<td>Jordan</td>
<td>1994</td>
<td>USD34m 1303 gtees in 2002</td>
<td>17 in 2002</td>
<td>Public shareholding company. Funds mainly from central bank, commercial banks and insurance co.s</td>
<td>SMEs and housing</td>
<td>USD 18m (2002)</td>
<td>50-75%</td>
<td>Disappointing that skewed to housing. SME impact appears minimal</td>
<td><a href="http://www.jlgc.com">www.jlgc.com</a></td>
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<td>Kenya Small Business Loan Guarantee Scheme (of British Aid to Small Enterprises)</td>
<td>Kenya</td>
<td>1994</td>
<td>No longer active.</td>
<td>1 Barclays</td>
<td>DFID</td>
<td>Small formal sector</td>
<td>Approx USD800k</td>
<td>75%</td>
<td>Has been analysed for lessons already</td>
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<tr>
<td>KOTEC (Korea Technology Credit Guarantee Fund)</td>
<td>Korea</td>
<td>1989</td>
<td>End 2003 USD 11.2 billion approx 70,000 SMEs</td>
<td>no data</td>
<td>Public corporation. Resources: 63% participating banks; 38.7% national government</td>
<td>Technology SMEs; or firms &lt;1000 employees; &lt;30 billion won assets</td>
<td>USD 872m 2003</td>
<td>100%; Normal max USD 2.5m Comm. 0.5 to 2% for SMEs (1% is the norm)</td>
<td>Gigantic scheme, controversial, culturally opaque and not suitable for methodology.</td>
<td><a href="http://www.kotec.or.kr">www.kotec.or.kr</a></td>
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<tr>
<td>PDAP (Projet de Developpement de l'Agriculture Peri-Urbaine de Bamako)</td>
<td>Mali</td>
<td>1994</td>
<td>Scheme was due to terminate in 1997</td>
<td>no data</td>
<td>All banking FIs (12);</td>
<td>Trust fund of Nacional Financiera - Government owned development bank</td>
<td>USD 0.16m (by 1995)</td>
<td>50%</td>
<td>No data, otherwise would have been interesting possibility</td>
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<td>NAFIN (Programme of Nacional Financiera de Mexico (NAFIN))</td>
<td>Mexico</td>
<td>1996 (operations began in 1997)</td>
<td>6,600 beneficiaries cumulative; 24,600 guarantees made in total for total of USD 47.5m guaranteed (up to end 2000); in 2000, 4,350 active guarantees USD 32.5m</td>
<td>no data</td>
<td>MSMEs productive projects in manufacturing. Also large firms for tech &amp; enviro improvements</td>
<td>Trust fund of Nacional Financiera - Government owned development bank</td>
<td>resources total USD 23.1m; started with USD 16m 2001</td>
<td>&lt; 50% wkg cap; &lt;70% fixed cap max USD 833k avge USD 29k Comm. 2.5-4% annual</td>
<td>Low volume for national scheme, looks passively managed and supply driven.</td>
<td><a href="http://www.nafin.gob.mx">www.nafin.gob.mx</a></td>
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<td>CCG: 2 schemes including one for SMEs and large firms, nb SMEs to obtain investment financing; and one for exporters.</td>
<td>Morocco</td>
<td>CCG created in 1949 but reformed under law 47-95 in 1996</td>
<td>CCG manages State &amp; external gtee funds. 1998-2000, overall activity (SMEs in brackets): 241 projects approved (201); 1,700 active guarantees; 1,670 SMEs served.</td>
<td>Main local banks</td>
<td>CCG: public entity with some private-sector directors. Own resources used to fund its two own guarantee funds; other programmes are funded using public funds and/or donor funds.</td>
<td>CCG: public entity with some private-sector directors. Own resources used to fund its two own guarantee funds; other programmes are funded using public funds and/or donor funds.</td>
<td>USD 653m</td>
<td>75% (60% large firms) of project cost, 50% total credit Fee 0.5 - 0.75% rapid procedure</td>
<td>Well established and resourced org, though volume low when last data gathered, has confidence of aid agencies</td>
<td><a href="http://www.enterplan.com">www.enterplan.com</a></td>
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<td>Caisse Centrale de Garantie: i) AFD PROPARCO</td>
<td>Morocco</td>
<td>1997; started in 1998</td>
<td>i) By November 2000, 8 projects approved for DH 120m (nearly USD11m) of investment. In all regions of the country. i) Donor supported (Agence Francaise de Development). Managed jointly by CCG and French Embassy. i) SMEs, investment credit. i) USD 27m; i) up to 50% of credit max USD1.6m; fixed fee 2.5%, rapid procedures.</td>
<td>i) SMEs, investment credit.</td>
<td>USD 27m</td>
<td>i) up to 50% of credit max USD1.6m; fixed fee 2.5%, rapid procedures.</td>
<td>see above</td>
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<td>Caisse Centrale de Garantie: ii) Fonds de Garantie de Credits pour la Mise a Niveau Enterprises (FOGAM)</td>
<td>Morocco</td>
<td>i) 1997</td>
<td>ii) Nationwide. 1998-2000: 12 projects approved for SMEs, 8 for large firms; total value of SME projects USD5m; CCG/FOGAM involvement: USD2m for SME projects. ii) Banque Nationale pour Developpement Economique (BNDE). ii) Partly financed by USAID. ii) Credit scheme modernising/ restructuring enterprises, for firms assets&lt; USD 3.7m &amp; investment plan &lt;= USD1.8m. Multiple 5 x fund USD 8m. ii) Credit to 70% project cost for 5-12 yrs, grace period up to 3 yrs; g'tee &lt; 60% ; 0.25 % Comm. Rapid procedures.</td>
<td>Multiple 5 x fund USD 8m</td>
<td>USD 8m</td>
<td>ii) Credit to 70% project cost for 5-12 yrs, grace period up to 3 yrs; g'tee &lt; 60% ; 0.25 % Comm. Rapid procedures.</td>
<td>see above</td>
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<td>Caisse Centrale de Garantie: (ii) Fond de Depollution Industrielle (FODEP)</td>
<td>Morocco</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
<td>Up to 80% of project, partly grant &lt; 40% &amp; partly credit 5-10 yrs, with 3 yr grace period.</td>
<td>see above</td>
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<td>Dar Ad-Damane, Bank Al Mahgrib</td>
<td>Morocco</td>
<td>2019 (cv Vigano: 1994)</td>
<td>Joint stock company (established to break CCG monopoly at that time) Capital from: gov. banks, insurance companies, enterprises; under Central bank. Funds: 80% national government; 20 percent participating banks. Oxio gene guarantee fund is newest. SMES assets &lt;USD 400k and &gt; 6 mths activity. Real estate excluded, aims at firms initiated by nationals abroad. USD 8.58m by 1993. Up to 60% 1st yr down to 50% 2nd yr; max USD18k twice per SME Fee USD230 is charged application.</td>
<td>USD8.58m by 1993</td>
<td>USD 8.58m</td>
<td>Up to 60% 1st yr down to 50% 2nd yr; max USD18k twice per SME Fee USD230 is charged application.</td>
<td>would be at least partially included in case study of CCG</td>
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<td>Guarantee Fund (FOGAR)</td>
<td>Paraguay</td>
<td>1995</td>
<td>Not currently operating (in process of reform). It is legally in place but no service has been carried out as yet; no guarantees exist either as requests or active guarantees. State (50%) and FIs (50%). Part of its intended reform is to make it a mixed fund, with contribution from private and public sectors. Initial funds of the new scheme will be USD800k. 50 to 80%; 2% p.a. fee for 80% guarantee; 4% p.a for 50% guarantee.</td>
<td>Micro and SMEs</td>
<td>USD800k</td>
<td>50 to 80%; 2% p.a. fee for 80% guarantee; 4% p.a for 50% guarantee.</td>
<td>Too early for case study</td>
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<td>Fondo de Respaldo para la Pequena Empresa</td>
<td>Peru</td>
<td>1996</td>
<td>Transitory fund. 4,610 operations (May 1998 to June 2002) for a total amount of USD21.2m.</td>
<td>10 (originally) but 1 bank user up to 2001 and a second started in 2002 to participate with caution</td>
<td>Initial capitalisation by the public treasury. Operated by national insurance co. chosen by public bid and supervised by the country’s banks and insurance superintendence</td>
<td>USD 20m capital 5yr project, due to end Nov 2001</td>
<td>USD 20.6m</td>
<td>Up to 50%, between USD5k and USD50k; 1 year term, renewable in special cases</td>
<td>Lack of recent data, not sure of continued existence</td>
<td><a href="http://www.mef.gob.pe/">http://www.mef.gob.pe/</a></td>
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<td>(FONREPE)</td>
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<td>Small Business Corporation*</td>
<td>Philippine s</td>
<td>1992 (GFSME 1983; merged to SBC in Nov. 2001)</td>
<td>GFSME: SBGF: Public funds (GFSME: national Treasury; SBGF: 3 public FIs and national Social Security System)</td>
<td>GFSME: no data SBGF: 3</td>
<td>Micro and SMEs various programmes</td>
<td>USD 9.31 m (by 1995); GFSME:USD 20m; SBGF:USD 29m</td>
<td>USD2m per region. Part of SME dev. agency project</td>
<td>30-70% of credits</td>
<td>previous studies suggest these funds were poorly managed, low volume, and very costly. Too early for any recent reform to be judged</td>
<td><a href="http://www.sbgfc.org.ph">http://www.sbgfc.org.ph</a></td>
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<td>Polish-British Enterprise Project</td>
<td>Poland</td>
<td>1995</td>
<td>Lublin &amp; Bialystok regions 6 funds, USD2m each. 1995-1999 595 g’tee ops. totalling USD13.9m</td>
<td>6 commercial banks and 1 savings bank</td>
<td>100% donor KHF/DFID</td>
<td>SMEs &lt; 100 employees in regions</td>
<td>USD2m per region. Part of SME dev. agency project</td>
<td>30-70% of credits</td>
<td>Larger projects and LG components praised by indep. evaluators. Have LGFs survived and thrived post-donor withdrawal in 2002/3?</td>
<td><a href="http://www.investromania.ro/frgc.html">http://www.investromania.ro/frgc.html</a></td>
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<td>Romanian Loan Guarantee Fund (Guarantee Fund for Private Sector Enterprises)</td>
<td>Romania</td>
<td>1993</td>
<td>USD59m g’teeed 1999. EUR2.9m only in 2002</td>
<td>98% nat. gov.; 2% paric. banks; initiated with Canadian Dev Bk TA &amp; funding; also EU, USAID, Dutch &amp; Italian support. No government subsidy or tax relief; shares profits among funders</td>
<td>Viable private sector SMEs</td>
<td>USD 20.08m by 1996 (LO); USD 25.6m in 1999 (EUC) EUR3.2 m 2002 (AECM)</td>
<td>30-70% of credits</td>
<td>Very low volume recently. Conservative low-risk management of fund resources</td>
<td><a href="http://www.investromania.ro/frgc.html">www.investromania.ro/frgc.html</a></td>
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<td>Republic of Slovenia Small Business</td>
<td>Slovenia</td>
<td>1991</td>
<td>To 2/96: cumulative 71 g’tees issued USD 16.1m. 1992-6 15 claims USD5.9m.</td>
<td>15 commercial banks; 1 other FI (Bannock)</td>
<td>100% national government</td>
<td>SMEs &lt;50 or 125 employees depending on type of business (Bannock)</td>
<td>USD 6.70 m by 1996 (Bannock)</td>
<td>60 to 90 % One-off fee of 0.8% &amp; annual Comm. of 0.8%</td>
<td>No recent data. Not member of AECM</td>
<td><a href="http://www.investromania.ro/frgc.html">http://www.investromania.ro/frgc.html</a></td>
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<td>Development Fund</td>
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<td>Khula Credit Guarantee Pty Ltd</td>
<td>South Africa</td>
<td>1996</td>
<td>USD28.2m in active guarantees; 3,700 SME clients by 2000, 700 of which received 'cartera' guarantees totalling more than USD29m</td>
<td>13 banks</td>
<td>100% national government</td>
<td>Small businesses. Offers 3 kinds of guarantees: individual; institutional and ‘cartera’</td>
<td>USD 53.5 (Pombo)</td>
<td>Generally 80% max loan USD78K exceptional 95%; 3 yrs max term avg. USD32k 1999</td>
<td>Informed that G’tee instrument performance distorted by role in black empowerment programme</td>
<td><a href="http://www.khula.org.za">www.khula.org.za</a></td>
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<td>Thembani International Guarantee Fund</td>
<td>South Africa</td>
<td>no data</td>
<td>Active guarantees for USD 3.2m</td>
<td>no data</td>
<td>Shared Interest fund of international fund THEMABANI and national development fund FRESA</td>
<td>Microenterprises in derivered regions; nb minority groups</td>
<td>no data</td>
<td>no data</td>
<td>see above</td>
<td><a href="http://www.sicgs.or.th">www.sicgs.or.th</a></td>
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<td>Small Industry Credit Guarantee Corporation</td>
<td>Thailand</td>
<td>2002; 1109 ops USD100m.</td>
<td>All the national commercial banks are shareholders and participate in operations</td>
<td>All the national commercial banks are shareholders and participate in operations</td>
<td>national government, public sector banks and private banks participating</td>
<td>start ups &lt; USD1m in net financial assets; all sectors especially manufacturing</td>
<td>USD120m 2002</td>
<td>50%</td>
<td>Up to 100% for very small deals Max USD260k Min USD5.2k; 1 yr renewable Comm. 2 - 2.75%</td>
<td>Low volume, high value transactions more medium sized firms</td>
<td><a href="http://www.sicgs.or.th">www.sicgs.or.th</a></td>
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<td>Small Business Development Corporation (SBDC)</td>
<td>T&amp;T</td>
<td>1991</td>
<td>About 500-600 g'tee operations annually plus otherfin &amp; non-fin services to SMEs End 1995, o/s g'tees USD3m</td>
<td>Commercial banks, credit unions and other entities participating in the Loan Guarantee Plan</td>
<td>Public corporation. National government + donor support e.g. EU. Raises signif. revenue from services covering about 50% budget.</td>
<td>Mainly SMEs with max. assets USD500k (excl. property) &amp; micro enterprises. Some types and sectors are excluded</td>
<td>USD 5.2 m on establishmen t Controlled by SBDC and invested in public bonds</td>
<td>Up to 85%; max guarantee is USD250k; term: &lt; 7 yrs. Comm. 5% or 2% of loan</td>
<td>Earlier evaluation favourable, working with banks on lending techniques, seems to have survived financially, playing sig role in small economy.</td>
<td><a href="http://www.sbdc.co.tt/">http://www.sbdc.co.tt/</a></td>
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<td>KGF (Kredi Garanti Fonu)</td>
<td>Turkey</td>
<td>1993 (or 1991 ?)</td>
<td>600 annual guarantees issued until 2001 for about EUR 36m and underlying credits of EUR 45m: Mainly Istanbul and Ankara. EUR 3.1 m, 281 ops. in 2002, EUR5.9m o/s</td>
<td>Private entity comprising over 30 public and private institutions and operating as a second tier agency. Mixed capital, primarily public. The fund was created by a union of all kinds of cooperatives.</td>
<td>Private institution owned equally by TESK, TOBB, KOSGEB, Halkbank and 2 foundations</td>
<td>SMEs &lt;200 employees. 90% of business is in industry</td>
<td>EUR 4.8m 2002</td>
<td>up to 80% up to EUR200k; up to 70% to Eur400k</td>
<td>Low volume for large country. Appears lack-lustre mgt.</td>
<td><a href="http://www.teskomb.org.tr">www.teskomb.org.tr</a></td>
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<td>Fondo Nacional Cooperativo de Garantia (FOGAR)</td>
<td>Uruguay</td>
<td>1995</td>
<td>Operations began in 1997; More than USD2m in guarantees has provided financing for MSMEs of more than USD10m for about 500 beneficiary firms</td>
<td>no data</td>
<td>Private entity comprising over 30 public and private institutions and operating as a second tier agency. Mixed capital, primarily public. The fund was created by a union of all kinds of cooperatives.</td>
<td>MSMEs from mfg &amp; other sectors in poorer regions. ST MT &amp; LT g'tees wkg cap dev cap &amp; investment. Also administers 3rd party funds.</td>
<td>no data</td>
<td>Up to 80% for ind. ops. 50-60% for ‘cartera’. Max amount depend on FI share in Fund; term 30 days to 10 yrs; Comm. 3.5% on average</td>
<td>Low volume and not much data</td>
<td><a href="http://www.cudecoop.org.uy/fogar.html">http://www.cudecoop.org.uy/fogar.html</a></td>
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<td>Guarantees fund of the Banco de la Republica Oriental de Uruguay (BROU)</td>
<td>Uruguay</td>
<td>1995</td>
<td>Financed operations for 923 firms USD 13.5 m to June 2003.</td>
<td>MIPEME / MyPE Global Multisectoral Program: BROU and IBD funds</td>
<td>MIPEME / MyPE Global Multisectoral Program: BROU and IBD funds</td>
<td>SMEs: all sectors g’tees USD loans for fixed cap, currency for wkg cap</td>
<td>Initially USD 2m</td>
<td>100% for up to 80% of project; max term 10 yrs; max loan USD40k; Comm 1% p.a.</td>
<td>Low volume over 8 years. Bank being recapitalised</td>
<td><a href="http://www.brounet.com.uy">www.brounet.com.uy</a></td>
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<tr>
<td>SOGAMPI (Sociedad Nacional de Garantías Reciprocas Para La Pequena Y Mediana Industria)</td>
<td>Venezuela</td>
<td>1990. Tried reform 1999 - 2001 but now under Industrial Bank</td>
<td>By 1999, 770 ops, credit USD35+m, o/s g'tees USD6m</td>
<td>Now appears to be 1 only</td>
<td>Joint stock company, State (81%), banks (4%), Fedemandia and unions, SME bodies (1%) and beneficiaries (14%). Mutual Guarantee Society law Aug. 1999. Stalled apparently since then</td>
<td>SMEs with up to 200 employees. Focus on manufacturing sector.</td>
<td>USD 50m by 1992 (ILO); USD 5m approx 1999</td>
<td>80- to 100% g’tee limits USD 8k-160k; max term of 2 years; Comm. up to 1.5%</td>
<td>Another attempt at establishing network of mutual g’tee societies. Very slow. Meantime new arrangement through state Industrial Bank which has a micro lending program. <a href="http://www.sogami.com.ve">www.sogami.com.ve</a></td>
<td></td>
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</tr>
</tbody>
</table>
Executive Summary

The Study

This case study of Chile forms part of the 2004 research effort mounted by the Financial Sector Team at the Policy Division of DFID into the role of credit guarantee schemes in promoting financial deepening\(^1\). The study aims to shed light on the factors and circumstances determining the degree, if any, of financial deepening that results from the operations of credit guarantee schemes (CGS), working with banks that are lending to Small and Medium Enterprises (SMEs).

We found it useful terminology to distinguish between direct deepening, which refers to effects linked directly to the current use of guarantee products by banks, from indirect deepening, which refers to broader effects on bank behaviour brought about by their experience of guarantee usage.

The CGS called Fogape in Chile was chosen as one of the four case studies because there was evidence from preliminary desk research that, since its reform and relaunch in 2000, there has been an explosion of interest in its guarantee offerings on the part of participating banks, so that the number of independent private-sector commercial banks participating in the CGS and volume of operations of the CGS had become large by 2003. In addition, the element of competition between participating banks was built into the design of the scheme. Both of these had been suggested\(^2\) as factors for success for CGS in promoting financial sector deepening in the preliminary work on the study.

The research method consisted of personal interviews with the management team of the CGS and with a selection of their participating banks, using structured questionnaires as the basis of discussions. The selection of participating banks was designed to provide examples of heavy and light users of the CGS, of new joiners, and of banks who were not members but who could be.

In practice, the study team was based in the Fogape offices for the field visit\(^3\) and had opportunities for extensive discussions with members of the management team beyond the formal interviews. A total of 7 banks were formally interviewed, and informal discussions were held with a representative of another participating bank. In addition, the team attended the regular monthly inter-bank meeting held in Fogape’s offices, and visited a high-level 2 day bi-national (Italy-Chile) parliamentary seminar being held in Santiago on the subject of systems of guarantees and financing for SMEs. This allowed an opportunity for a short personal interview with the Deputy

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\(^1\) The opinions expressed in this Case Study are those of the consultants and do not necessarily reflect the opinion of the UK Department for International Development or the official policy of the UK Government.

\(^2\) Please refer to the Comprehensive Report on the GCS Study for details of the methodology including the thesis.

\(^3\) Carried out in Santiago between 2 and 6 August 2004.
Head of the Banking Supervisory Office (SBIF), who had been a key figure in the reform of Fogape in 1999-2000.

**Key Findings**

**Evidence for Direct Deepening**

The main evidence for financial sector deepening of the direct kind is summarised below.

- The number of banks addressing the SME sector through the CGS route had increased from 3 to 18 following its relaunch.
- Banks generally cited the CGS as an important tool, though not the prime one, in their strategic approach to the whole sector.
- All banks interviewed stated that:
  - their interest in the CGS products was commercial and profit-oriented and not a compliance with government policy on SME support;
  - their use of CGS had enabled them to extend the outreach of their commercial lending operations beyond the frontier that applied before the CGS products were available. This extension of outreach was in terms of borrowers who would not otherwise get access to funds, or better terms and/or greater access for existing customers. The nature and degree of “additionality” varied from bank to bank and could not be precisely quantified. Note that with this CGS there is no requirement for the lender to refrain from taking other available collateral;
  - with the exception of one bank that had internal system problems, all banks wanted to increase their use of the CGS in future;
  - 2,500 front line bankers had been trained in the use of the guarantee products to service small and micro enterprises; and
  - banks had responded to their competitors introduction of new CGS-assisted lending products by matching their rivals' offerings, thus broadening the choice available to SMEs.

In addition to the effect on banks, the successful take-up of Fogape products had led CORFO, a government-owned financial support agency, to plan the introduction in 2004 of a similar product to that of Fogape, aimed at the next SME sub-segment upwards in terms of business size.

The average risk share of the guarantee has been falling, from 79 percent in 2001 to 71 percent in 2003, so that banks are taking more of the risk over time.

**Indirect Deepening**

Banks denied that their non-guaranteed SME lending operations had been generally affected by their experience with guaranteed lending. However, several admitted that it had already resulted in some marginal cases of departures from existing policy, and others that it could be an effect in the future. One bank had already considered...
Do Credit Guarantees Lead to Improved Access to Financial Services? / Case Study - Chile / February 2005

ways in which it could retain the guarantee premium by taking on the whole risk while another stated that the high quality information about arrears and losses in the SME sector coming from Fogape was already leading to internal discussions about reviewing risk pricing for non-guaranteed loans.
1 Case Study - Chile

Introduction to Chile

Chile is a country of 15 million people, with a GDP of USD 72 billion in 2003. After averaging growth of GDP of 5 percent per annum for the whole period 1986 to 1997, the rate of growth slowed down following the emerging market crisis of 1998. GDP growth was 2.2 and 3.3 percent in 2002 and 2003 respectively. The IMD’s World Competitiveness Yearbook 2004 places Chile very highly, in fact second out of 60 countries measured.

Exports accounted for 29 percent of GDP in 2003 (20 percent in 1998). Led by copper, their value grew by 16 percent between 2002 and 2003. Export performance has, however, been volatile over the last five years reflecting global demand swings for raw materials.

The SME sector accounted for an estimated 13 percent of total sales of all businesses in Chile in 2001, which gives some idea of its contribution to GDP. It is relatively unproductive however, employing about 55 percent of the labour force, and makes little direct contribution to exports.

The Chilean financial sector is rated highly by international standards. Sovereign rating is A or A- investment grade, interest rates have been kept in low single digits since 2001 (there was a financial crisis in 1998 which took rates above 12 percent temporarily), and inflation has been below 5 percent since 1998, and in most years below 3 percent.

On Transparency International’s corruption index Chile is ranked 20th out of 133 countries, just behind the USA.

Assessment of the Enabling Environment

Chile is a medium-sized, relatively wealthy country, with GDP per capita approx USD 5,000 (USD 9,000 on a purchasing power parity basis). It has well developed economic, political and legal institutions, the latter developing rapidly in the post-Pinochet era since 1990. OECD stated that “In a region known for its turbulence, Chile stands out as a particularly stable and resilient economy……. Chile has also set itself up as a benchmark for other emerging markets engaged in structural reforms, with its sound fiscal and monetary policies, relatively well-developed financial system and up-to-date institutions”. The policy environment in Chile is strongly market oriented.

Chile has had the benefit of the experience of a sustained period of growth at 7 percent per annum in the 1990s, when all banks were participating and learning to grow in buoyant markets, including that for SME finance. This experience and

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4 International Institute for Management Development
5 Turnover below UF 25,000, approx. USD 650,000.
6 OECD, December 2003 note.
Appendix A5 – Case Study - Chile

professionalism was useful during and after the emerging markets crisis of 1998, which affected Chile.

Special attention has been given to the SME sector and its financing since the 1998 crisis, which led to much higher unemployment rates. A high level Public – Private Committee on Small Business has overseen the introduction of various enabling laws and instruments of support. The policy formation is informed by research on the sector, and by international comparisons, for example of productivity, training and technological level.

The banking sector is highly competitive. One state-owned bank, 9 other domestic banks and 13 international banks operate in Chile. There has been some consolidation in recent years, with Banco de Chile buying Banco Edwards, and Banco Santander of Spain buying Banco Santiago. On the other hand, there are new entrants into the banking market, such as HNS Bank which is an SME specialist operator. Within the SME sector there is considerable competition with no one bank having a dominant position. Our interviews revealed that banks have a variety of strategic approaches to the sector, with some going for a broad portfolio and others concentrating more on specific sub-segments.

All the banks interviewed regard the SME sector as an important and profitable segment of the market. Most stated that it was the most profitable area, considering margins and NPA rates. Competition in lending to large firms and to the personal sector had driven down returns. In 2003, the Minister of Economy even made a reference to the high rates of interest being charged in Chile to small firms as being almost an abuse.

The Central Bank of Chile sets base-level interest rates and handles other aspects of financial policy independently, and there is a separate well-respected Supervisor of Banks and Financial Institutions (SBFI), whose office and senior executives are known to be politically independent.

Liquidity is not constrained and banks have plenty of funds to lend.

An important factor within the enabling environment, not previously identified, is the availability of commercial credit references and information. In Chile, this is handled by a well-respected bureau called DICOM, to which all banks subscribe. DICOM has good coverage even within the SME sector. The risk of wilful as opposed to involuntary default is reduced in such an transparent credit environment.

The number of micro enterprises (with turnover below UF2,400, approximately USD55,000) and small enterprises (with turnover below UF25,000, approximately USD650,000), was estimated at 1.2 million firms in 2001, of which just over half were formally registered. The number of such firms is estimated to have grown strongly between 1994 and 2001, by about 22 percent.

According to a major government-sponsored study on the sector published in May 2003\(^7\), the proportion of SMEs with access to credit from the financial system in the year 2000 was 40 percent for micro enterprises and 62 percent for small enterprises. For medium sized enterprises, those with sales between USD650,000 and USD2.6

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\(^7\) La Situación de la Micro y Pequeña Empresa en Chile, Comité De Fomento de la Micro y Pequeña Empresa, Gobierno de Chile, March 2003.
million, the figure was 72 percent. These percentages had not varied very much over
the previous five years. The proportion of total financial system debt taken up by
micro enterprises had increased however from 7.8 percent in 1994 to 9.3 percent in
1999, while small enterprises maintained a level of about 13 percent.

We were informed that multibanking by SMEs is very common in Chile. This is
unusual by international standards. Most SMEs in Chile try to have relationships with
at least two banks. This is itself a feature which promotes competitive attitudes on
the part of both bankers and clients.

The percentage of non-performing assets in total debt for each size sector of
business is calculated by SBIF. The latest figures at the time of writing are for the
year 2000, when NPA rates were still elevated from the crisis of 1998. These figures
were 5.6 percent for micro enterprises, up from a range of 2.9 to 3.8 percent in the
previous 5 years, and 3.4 percent for small enterprises, up from 1.6 to 2.8 percent. It
is almost certain that, more recently, NPA rates for the SME sector have come down
towards historic averages. Overall NPA rate for the whole enterprise sector was 1.7
percent in 2000, up from around 1 percent historically.

In terms of the study thesis and macro factors for success and failure, Chile scores
highly on all the factors identified, as set out in Table 1.

### Table 1 Assessment of Enabling Environment against Factors for Success

<table>
<thead>
<tr>
<th>Factors for Success</th>
<th>Factors for Failure</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Macro Factors</strong></td>
<td><strong>Assessment</strong></td>
</tr>
<tr>
<td>1 an open, competitive banking environment wherein there are a number of independent banks, a majority of which are interested in expanding their client base, establishing niche markets, or protecting market position;</td>
<td>• a thin banking sector that is controlled by a few powerful vested interests, in which banks are sufficiently profitable with their existing, limited clientele to support the financial and/or political ambitions of those controlling interests;</td>
</tr>
<tr>
<td>2 a monetary and regulatory environment that is conducive to lending to SMEs, in particular with sufficient liquidity and stable interest rates that allow for appropriate risk/return pricing;</td>
<td>• restricted liquidity for SME lending and/or excessive interest rate risk that discourages opening up new markets;</td>
</tr>
<tr>
<td>3 a dynamic and/or expanding business sector within which viable opportunities are available for exploitation by new entrants including MSMEs;</td>
<td>• a thin business sector that is not under pressure to change or reform, in particular to become more inclusive;</td>
</tr>
<tr>
<td>4 a framework for business (political, policy, legal, regulatory and social) that, in its application as well as its theory, is supportive of enterprise in</td>
<td>• endemic corruption and/or incompetence that distorts and/or restricts the operation of market forces and discourages MSMEs from</td>
</tr>
</tbody>
</table>

Where 1 = "very much so"; 2 = "to some extent"; 3 = "only slightly"; 4 = "not at all".
Factors for Success  |  Factors for Failure  |  Assessment
--- | --- | ---
all its forms including MSMEs.  |  entering the formal economy.  |  1 2 3 4

Fogape Credit Guarantee Scheme

FOGAPE, Fondo Garantia para Pequenos Empresarios, Fund of State Guarantee for Small Industrialists, was established in 1980 under its own legislation. Until the aftermath of the economic and financial crisis of 1998, its activities were very limited. Only 3 banks participated during that period, including the only state-owned bank, Banco Estado, which was responsible for management of the Fund. There were only 200 operations in 1998. At times during this early period there were political pressures which resulted in Banco Estado directing the Fund to particular sectors, for example start-up bus operators who are independent small firms in Chile.

In the period 1998-1999 discussions were held with a view to relaunching the guarantee scheme. The key discussions were with bankers and representatives of the Supervisor of Banks and Financial Institutions (SBIF). As a result of these discussions the basic design was not changed but the guarantee itself was made much more liquid and hence useful to bankers. It is paid out in full within 15 days of the claim being lodged and the claims procedure has been simplified and streamlined. As a result, between 1999 and 2004 Fogape has expanded to an annual volume of 30,000 operations with 18 participating banks.

Fogape is a classical guarantee fund, which shares the risk of default on eligible loans in return for a guarantee premium. The commercial relationship is between Fogape and the lending bank. Banks select which loans they wish to be guaranteed. All the risk appraisal is done by the bank. Fogape merely checks that the loan is eligible for a guarantee. The three main criteria are that: the borrower business is within the size limit defined by turnover; the loan is within the eligible size limits and term; and the total exposure of the guarantee fund to the borrower over all loans from all banks is within the allowable limit of UF 5,000, approximately USD 130,000. The borrower has no direct relationship with the guarantor. In fact, in many cases the borrower will be unaware that his/her loan is subject to a guarantee. Banks do not have to provide for guaranteed loans if they become non-productive.

A special feature of Fogape is that guarantee capacity to support the next quarter’s lending is auctioned among the participating banks. Competitive bidding is done by nominating the risk percentage that the bank requires Fogape to cover for the amount it bids. Banks which bid for lower guarantee percentages will have their requested amounts granted in full, while others are likely to have theirs cut back. The maximum fund coverage is now normally 70 percent but one third of its capacity, directed at term loans over three years, and loans to exporters and emerging enterprises (less than 3 years of age), is allowed to go up to 80 percent.

**Institutional Framework**

The fund capital is 100 percent supplied by the government. The sponsoring ministry is Ministry of the Economy. The fund is managed day to day by a special unit within Banco Estado, the state owned bank, which charges the fund an administration fee. The management team is supervised by the Financial Controller of Banco Estado.
The fund accounts are externally audited and Fogape is supervised directly by the SBIF.

A consultative committee, with representation from the four largest banks, three associations of SMEs and the Ministry of Economy, as well as the Fund supervisor within Banco Estado, meets quarterly. In addition, there is a short monthly inter-bank meeting hosted by Fogape, at which detailed results of its operations, analysed by bank, are presented and discussed.

The financial structure of the scheme is designed to achieve partial sustainability. In principle, the aim is for the income from guarantee commissions charged to borrowers to be sufficient to meet claims, net of recoveries, plus administrative costs. The investment income on the fund capital is then used to increase the fund capacity. The maximum leverage of the fund is limited by law to a multiple of 10.

The legal rules of Fogape lay down a formula, based on the quality of the portfolio, for provisions against future outstanding claims. The current actual amount of provisions is approximately 4 percent of the outstanding guarantee portfolio. This compares well with the official figures for Non-Productive Asset (NPA) rates on the SME sector loans as a whole.9

The fund paid out claims, net of recoveries, at the rate of between 1.04 and 1.28 percent of the average outstanding guarantee portfolio per annum in the years 2001-2003. Vintage analysis of guarantees extended has shown that the default rate, net of recoveries, after three years, is a total of 2.5 percent. Commission was at 1 percent per annum of the guarantee, but since June 2004, it has been increased to a range of between 1 percent and 2 percent depending on the claims performance of the bank concerned.

Findings

Assessment of the CGS

Design Philosophy and Strategic Approach

In our discussions with Fogape and the banks, it became clear that the approach of Fogape very much reflected the second, third and fourth success factors of our thesis. That is, FOGAPE takes the “financial sector approach”, has an understanding and empathy with market forces, and has a long term approach emphasising institutional and financial stability.

The importance of the buy-in from senior managers and those in charge of SME lenders at participating banks is also recognised, as in the first factor, “an influential champion within the lenders”. Here the role of the internal Supervisor of Fogape, who is a member of Banco Estado’s top management, as well as that of Fogape’s Manager, are important in helping to maintain relationships with opposite numbers in the banks.

The institutional arrangements allow the banks a consultative and advisory role only through their representation on the consultative committee, which is seen as an

9 See below.
example of tripartite co-operation between SME representatives, banks and the CGS itself. This is in line with the fifth success factor of the study thesis.

While there is enthusiasm on the part of bankers for Fogape’s products, and “ownership” in the sense of recognition that Fogape is working for their benefit, there is so far no actual ownership or participation in governance by lenders, the sixth factor of the study thesis.

The reform of Fogape needed to rebuild the confidence of banks, whose experience of some government sponsored schemes, including to some extent that of the old Fogape, had included occasions of being pushed to make losses to satisfy political goals. SBIF played a key and pro-active role here through sponsoring and aiding the reform. It consulted banks in joint meetings about their problems in addressing the SME sector, where there was lack of security, and used SBIF expertise to draft new rules for Fogape and develop and streamline the guarantee instrument so that it would match the needs of the banks. SBIF’s involvement encouraged the banks to respect Fogape and take it seriously. This is an extra element in the immediate CGS environment, which may have lessons for other contexts.

Fogape regards the banks as its primary clients, and sees itself as delivering a product to them which assists them in their commercial operations. To bring the banks on board, Fogape has marketed its products strongly. It develops close and frequent bilateral contact relationships with the key managers within each bank. Fogape is strongly conscious of the need to keep administration costs down for its customers and to respond to their requirements for extensions and modifications of the product and service. It also provides a lot of support in training front line bankers in the use of the guarantee system. By 2004, 2,500 bankers had received training from Fogape staff. Fogape uses professionally developed software to interface with the banks’ systems as much as possible on guarantee operations and to keep paper-based operations to a minimum. It also keeps its headcount to a minimum, outsources service functions from Banco Estado, and supports the distribution of its products through training and promotion visits.

Beyond the guarantee products, Fogape is aware that it is delivering high quality information about the actual risk of lending in the sub-sector covered by guaranteed loans. Detailed results for the whole portfolio of guaranteed loans, analysed by bank, are distributed each month at the informal inter-bank meeting. This information is uniquely up to date and precisely targeted to that sector, and is not available from any other source.

An additional aspect of their approach that was not highlighted in our factors for success is the use of the CGS to stimulate competition between the banks in their SME operations. Our observations indicated that this is another factor that leads to financial sector deepening. The quarterly auction, referred to above, is a clearly competitive process. At inter-bank meetings the atmosphere is of friendly professional rivalry, in a context where there is complete transparency of operations and results. Another aspect is the differential commission rates introduced from July 2004. These are directly related to claims performance of each bank, are transparent, and directly affect banks’ competitive positions in the market place. If claims rise beyond a threshold, Fogape will exclude a bank from participation until performance improves satisfactorily. This has already happened in one case.
Negative Evidence

None of the banks interviewed cited any negative effects from the credit guarantee scheme. Our observations clearly indicated were that the conditions attached to the scheme had not resulted in any distortions in the market place.

One or two bankers pointed out that the system had not been in place for sufficient time for it to demonstrate complete long-term reliability, compared with traditional collateral methods, or for its routines to become so established and well known that internal costs were minimised.

One aspect of the scheme illustrates a possible trade-off between short-run acceptability and the degree of deepening. Although Fogape does disallow the use of the guarantee to refinance old loans, it does not, unlike many CGS schemes, place any restrictions on banks taking collateral to support a loan in addition to its guarantee, which normally leaves 30 percent of the risk with the bank. Banks vary widely in their approach to this, with some mainly using the Fogape guarantee alone, and others taking at least some additional security. Taking collateral involves extra costs and delays for both bank and borrower. Banks told us generally that guaranteed loans have a lower amount and/or poorer quality of collateral than it would have had to be the case for the loan to be granted without a guarantee. An internal analysis of loans with and without collateral, based on a data set covering 80 percent of operations during the four years to December 2003, showed that the larger the guaranteed loan, the more likely additional collateral would be taken. This obviously partly reflects the availability of collateral and the associated costs. There is no trend analysis available from this data set at present.

Some of the smaller banks who have joined the scheme relatively recently claimed that they would always prefer the guarantee to collateral, even when the latter was available, given the balance of costs, delays and liquidity in the event of a default (delays in realising sales of assets).

With Fogape currently suffering from a capacity constraint due to the maximum leverage having been reached on the present fund capital, the question of rationing guarantee allocations has become more of an issue. This is true not only for Fogape, which could consider restrictions (for example, designed to encourage graduation of borrowers out of the scheme), but also for some banks. One bank said that its commercial managers were requesting its risk management unit to relax its policy that Fogape guarantees should always be taken for eligible loans. The commercial managers hoped thereby to increase the proportion of guarantee business that was truly additional, principally to attract new clients to their bank, from its current level of an estimated 20 percent. This would imply a trend to increase the proportion of loans for which the guarantee was the only external security.

Summary

The assessment of FOGAPE against our micro factors for success and failure is set out in Table 2.
### Table 2 Assessment of FOGAPE against Factors for Success

<table>
<thead>
<tr>
<th>Factors for Success</th>
<th>Factors for Failure</th>
<th>Assessment</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Micro Factors</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1 an influential “champion” (or champions) within the lender(s) who actively promotes the CGS for appropriate commercial reasons;</td>
<td>lack of support or lack of understanding of the commercial logic of the CGS within the lender(s);</td>
<td>✓</td>
</tr>
<tr>
<td>2 a “financial sector” approach to CGS design that focuses on the goal of achieving a permanent deepening of the financial sector;</td>
<td>a “social sector” approach that focuses exclusively on a short-term goal of pushing finance to the SME sector and the use of financial institutions as conduits for that purpose;</td>
<td>✓</td>
</tr>
<tr>
<td>3 an understanding of and empathy with market forces, particularly for providers of financial intermediary services;</td>
<td>an emphasis on the social obligation of lenders or compliance with laws, regulations or policies</td>
<td>✓</td>
</tr>
<tr>
<td>4 a long-term approach that emphasises institutional and financial sustainability, with objectives directly related to financial sector deepening, even if project interventions are short or medium term in duration;</td>
<td>a project approach that focuses on short-term objectives that are limited to the period of the project intervention, rather than directly related to long-term financial sector deepening;</td>
<td>✓</td>
</tr>
<tr>
<td>5 extensive transfer of appropriate lending “technology” in terms of policies, procedures, methodologies and systems through carefully focused technical assistance;</td>
<td>reliance on targets for achievement of project lending objectives without regard for the ongoing sustainability of institutional processes;</td>
<td>✓</td>
</tr>
<tr>
<td>6 a participative approach that achieves a balanced partnership between donors, CGS and lenders for achievement of agreed objectives;</td>
<td>a paternalistic approach that imposes a CGS project on reluctant lenders who do not understand or do not agree with the stated objectives;</td>
<td>✓</td>
</tr>
<tr>
<td>7 ownership by lenders of the CGS stemming from clear and significant benefits to lenders in terms of assistance to open up new markets for profitable commercial exploitation.</td>
<td>coercion of lenders through a “carrot” (non-transparent benefits unrelated to financial sector deepening) and/or “stick” (pressure from political or regulatory authorities) approach.”</td>
<td>✓</td>
</tr>
</tbody>
</table>

### Overall Financial Deepening Performance and Impact

The FOGAPE CGS has been a major success story in terms of acceptance and rapid growth. The awareness of it in the banking sector is high, its product delivery is trusted, and its commercial value is highly appreciated. FOGAPE has extended its...
coverage partly in response to bank requests to a wider range of instruments including factoring. In the climate of the capacity constraint, some banks were prepared to entertain at least in principle accepting a higher risk level for themselves as a trade-off for marginally more capacity, though most saw the need for substantial extra resources to be put in to multiply the system capacity. At this stage, banks were unreceptive to the idea that they should themselves invest in the system from which they were benefiting.

The proportion of loans to the micro and small business sector covered by Fogape guarantees is not in itself a measure of financial deepening, but it is a measure of the impact on bank operations. For two of the major banks interviewed, this figure was available at 17 percent and 13 percent respectively.

For impact on SMEs, there is no doubt that competitive pressures are reducing margins in the SME sector, and that the guarantee product facilitates the approach of some banks to the micro and small business sub-segment. The guarantee serves as another competitive tool, particularly with respect to businesses new to their bank or new to the banking system.

Assuming that the capacity problem is solved, (by a further injection of capital), the degree of deepening, both direct and indirect, can be expected to increase over the coming years. Competitive pressures and the feedback of information on the low level of risk shown by the guaranteed portfolio will be the drivers. Rationing by Fogape may assist this process, though it would complicate what is now a very simple product and is likely to be opposed by banks.

Key factors explaining this result include the following.

- enabling environment:
  - open, transparent and competitive banking system, with good profit opportunities in SME segment, held back in part by lack of collateral;
  - absence of interest rate controls constraining effective margins;
- CGS institutional:
  - role of SBIF in bringing banks on board in the reform and relaunch, listening to their requirements, tailoring Fogape to suit their commercial needs, but not pushing Fogape or SME business;
  - good governance, respected by banks: Fogape supervised by SBIF, as they are;
  - as soon as one bank starts to explore and use the CGS, the others will follow so as not to lose the competitive edge. What is crucial is to wait for banks to take it up, and not to push it using non-commercial arguments;
  - professional and transparent approach to commercial relationships with participating banks, encouraging competition on the basis of full and open information wherever possible.
• CGS factors (operational).
  • making guarantee cheap and effective, i.e. simple, clear and liquid, for banks to use;
  • minimising bureaucracy;
  • continual training of commercial front-line bankers to use the product. Fogape has provided this possibly more than the bankers themselves, at least initially;
  • maintaining a high level of contact with bank clients, both nominated fund representative and their bosses, both informal bilateral and multilateral;
  • leading in technology (software) to make procedures streamlined at both ends;
  • responding to reasonable bank requests, for example promoting to their SME clients if they ask.

Suggestions for Improvement

Targeting and Rationing

Loans which are extended without any other collateral, but which do not fall into the specific categories of over 36 months term, emerging enterprises, exporters, should also qualify for the 80 percent maximum guarantee coverage. This may require an adjustment to the maximum coverage of the other two sectors to below 70 percent in order to rebalance capacity.

Operational

Currently, there is little incentive, other than naming and shaming those whose performance is weak, for banks to maximise their recoveries from defaults, as the full guarantee on outstanding principal and accrued interest is paid out within 15 days. Fogape has not met its target for amounts recovered from defaults.

Recovery performance could be either:

• given more than its current weight in the risk model which determines commission rates charged to borrowers by each bank; or
• included in the calculation of allowable bid capacity for the next quarter, at present unrestricted if 80 percent or more of the previous quarter’s capacity has been used up.

Replication Possibilities

The question to be asked is whether a CGS with Fogape’s approach and basic design would still work to produce financial deepening in a less favourable banking environment.
A multibank system serving a group of banks competing within a profitable SME market might work, but a priority might be to build a commercial credit information system to deter wilful defaulters.
Executive Summary

The Study

This case study of the Credit Guarantee Company for Small and Medium Enterprises SAE (CGC), Egypt, forms part of the 2004 research effort mounted by Financial Sector Team, Policy Division, DFID into the role of credit guarantee schemes in promoting financial deepening. The study aims to shed light on the factors and circumstances determining the degree, if any, of financial deepening that results from the operations of credit guarantee schemes (CGS), working with banks that are lending to Small and Medium Enterprises (SMEs). Financial deepening refers primarily to increasing access to financial services by those previously unable to access such services, but also to the appropriateness of those services to the needs of the new target groups.

We found it useful terminology to distinguish between direct deepening, which refers to effects linked directly to the current use of guarantee products by banks, from indirect deepening, which refers to broader effects on bank behaviour brought about by their experience of guarantee usage.

The CGC in Egypt was chosen as one of the four case studies because there was evidence from preliminary desk research that it had achieved sufficient scale and operational efficiency to be financially sustainable. Other factors that interested the researchers included its legal form as a private joint stock company, and its relationship with CGC Consult, a joint venture consulting company.

The research method consisted of personal interviews with the management team of CGC and with a selection of their participating banks, using structured questionnaires as the basis of discussions. The selection of participating banks was designed to provide examples of heavy and light users of the CGS, and of banks which are shareholders as well as those which are not.

The researcher was greatly assisted during the field visit by the officers and staff of CGC and CGC Consult and had opportunities for extensive discussions with members of the management team beyond the formal interviews. A total of three banks and one NGO were formally interviewed. In addition, the researcher had the opportunity to meet with the Director of the EU funded Industrial Modernization Center.

1 The opinions expressed in this Case Study are those of the consultants and do not necessarily reflect the opinion of the UK Department for International Development or the official policy of the UK Government.
2 Carried out in Egypt between 12 and 16 September, 2004.
Key Findings

Evidence for Direct Deepening

The main evidence for financial sector deepening of the direct kind was:

- from 9 original shareholder banks, CGC has expanded to 34 banks under contract;
- partner banks interviewed generally cited the guarantee provided by CGC as essential to their ability to service the SME sector;
- some of the more active partner banks are developing increasingly large portfolios of loans to SMEs, using CGC guarantees without additional security, thus lending with only partial security coverage of the funds at risk.

All banks interviewed stated that the CGC guarantee was an essential factor in their ability to deal with the SME sector and their use of the CGC guarantee had enabled them to extend the outreach of their commercial lending operations beyond the frontier that applied before the CGC products were available. This extension of outreach was to borrowers who would not otherwise have had access to loan funds because of their lack of credit history and acceptable security. CGC does not oblige the lender to refrain from taking other available security - some do while other do not;

Those banks that had decided to target the SME sector were very conscious of the competitive advantage of using CGC lending products to match their rivals' offerings and increase market share. Not all of CGC’s partner banks had made a strategic decision to set the SME sector as a target market: some banks were focused on other sectors and had not put any priority on the SME sector, while others expressed some interest but had experienced relationship problems or used alternative support mechanisms for their approach to the sector (largely the Social Fund for Development, which offers subsidised interest rate loans).

The most active partner banks indicated that their interest in the CGC product was commercial and profit-oriented in nature. However, some banks indicated that their involvement with CGC came out of a desire to support government policy on SME development or a perceived social obligation.

CGC had an impact on the participating banks by exposing them for the first time to SME lending policies and mechanisms. CGC also influenced its partner banks by continually reviewing best practice lending policies and mechanisms and working with participating banks to develop their understanding and awareness of this market segment.

The extent of CGC outreach represents a maximum of about 3 percent of the total number of SMEs, according to a 1996 census. Given this limited outreach, we conclude that financial sector deepening from CGC operations has been limited. Competing mechanisms for support of banks’ lending to SMEs, primarily the Social Fund for Development, are not market driven in the way CGC is and tend to reduce the potential market for CGC products.
Indirect Deepening

Banks denied that their non-guaranteed SME lending operations had been generally affected by their experience with guaranteed lending. In fact, most banks indicated that they would be unable to lend to the target markets supported by the CGC products, including SMEs, without a guarantee or other means of support.
Case Study – Egypt

Introduction to Egypt

Egypt is a lower middle income country, with a population of 67.3 million growing at 1.8 percent per annum and a labour force that is currently growing at 2.9 percent per annum. GDP was USD 63.04 billion in 2003, down from USD 61.16 billion in 2002 and significantly down from an average 3.1 percent growth rate over the previous two years. The informal economy represents approximately 35 percent of total Gross National Income. GNI per capita (Atlas method) is USD1,360 equivalent (2003), with approximately 17 percent of the population living below the national poverty line.

Exports of goods and services made up 21.7 percent of GDP in 2003, a significant increase over the 16.2 percent recorded in 2002. At the time of the country visit, average deposit rates on 3 month deposits were approximately 7.7 percent and on 91 day T-bills were around 11.0 percent, and the discount rate was 10.0 percent. When the Egyptian Pound was floated (subject to restrictions) in January 2003, the inflation rate rose from 2.4 percent in 2001/2002 to 3 percent in 2002/2003 and 5.2 percent in 2003/2004. Official inflation rates are expected to reduce to about 2.7 percent in 2004/2005.

Standard and Poors’ assigned an inaugural credit rating of “investment grade” BB+ to Egyptian long-term, foreign currency sovereign debt. As a BB+ rated country, Egypt would rank with Greece, Hungary, Poland, or Tunisia. Moody's assigned a Ba1 rating to Egyptian sovereign debt, two steps below investment grade.

The Government of Egypt uses a working definition of MSMEs that comes from a study conducted by the Economic Research Forum, as shown in Table 1.

Table 1 Egyptian Definition of MSME

<table>
<thead>
<tr>
<th></th>
<th>Labour</th>
<th>Fixed Assets (LE)</th>
<th>Sales (LE)</th>
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<tbody>
<tr>
<td><strong>Manufacturing and construction</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Micro</td>
<td>1-4</td>
<td>&lt;25,000</td>
<td>&lt;100,000</td>
</tr>
<tr>
<td>Small</td>
<td>5-49</td>
<td>25,001 - 5 million</td>
<td>100,001 – 10 million</td>
</tr>
<tr>
<td>Medium</td>
<td>50-99</td>
<td>5 million – 10 million</td>
<td>10 – 20 million</td>
</tr>
<tr>
<td><strong>Services and Trade</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Micro</td>
<td>1-4</td>
<td>&lt;25,000</td>
<td>&lt;100,000</td>
</tr>
<tr>
<td>Small</td>
<td>5-9</td>
<td>25,001 – 500,000</td>
<td>100,001 – 1 million</td>
</tr>
<tr>
<td>Medium</td>
<td>10-19</td>
<td>500,001 – 2 million</td>
<td>1 – 4 million</td>
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According to the Ministry of the Economy, MSMEs represent more than 90 percent of the total number of productive organisations in Egypt and over 98 percent of total

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3 Constant dollars at an exchange rate of USD1.00 = LE6.24
4 Doing Business – Snapshot of Business Environment, World Bank / IFC
6 Moody’s 2003/2004 report
private sector enterprises. They produce 80 percent of private sector value added and account for two thirds of the labour force (three quarters if agricultural and public sector employment are excluded). As many as 88 percent of MSMEs are in the informal sector. Table 2 sets out the number of non-agricultural MSMEs by size, according to the 1996 census.

**Table 2 Number of Egyptian Micro and SMEs**

<table>
<thead>
<tr>
<th></th>
<th>Number</th>
<th>Percentage of private companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Micro</td>
<td>1,533,489</td>
<td>92.7</td>
</tr>
<tr>
<td>Small</td>
<td>101,289</td>
<td>6.1</td>
</tr>
<tr>
<td>Medium</td>
<td>15,016</td>
<td>0.9</td>
</tr>
<tr>
<td>Total</td>
<td>1,649,794</td>
<td>99.7</td>
</tr>
</tbody>
</table>

Despite the prevalence of micro and SMEs in the Egyptian economy, their performance is severely limited by: inadequate financing; few affordable sources of training, consulting and other needed services; and a difficult business environment whose complex and inefficient regulatory framework raises the cost of doing business.

On Transparency International's corruption perception index, Egypt is ranked 70 out of 133 countries.

**Assessment of the Enabling Environment**

The Egyptian banking sector is one of the oldest and largest in the region. Capitalising on its comparative advantage in the service sector, financial sector growth potential and economic and political stability, Egypt is moving steadily towards becoming the biggest financial centre in the region.

The Central Bank of Egypt (CBE) is the regulatory body responsible for setting and coordinating monetary and banking policies in Egypt. It is responsible for supervising, controlling and enhancing disclosure and stability in the banking sector. June 2003 banking legislation established CBE independence in choosing monetary instruments to achieve the common goals set by a coordination committee.

Banking reform started in the mid-1970s when foreign banks were allowed to operate in Egypt. In the 1990s, the banking sector was completely liberalised, with a focus on promoting transparency and use of adequate accounting and supervision standards. Banks are required to publish their financial statements on a quarterly basis in compliance with International Accounting Standards (IAS). Service fees and bank charges were freed, banks were empowered to determine their lending and deposit rates and spreads, and competition between banks was left for market forces. Meanwhile the role and size of the interbank market has become quite significant.

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7 USAID Egypt (http://www.usaid-eg.org/detail.asp?id=12)
8 Source: CAPMAS 1996 Establishments Census, Ministry of Economy and Foreign Trade Draft National Policy on SME Development in Egypt, 1998. Based on an employment definition of SMEs (micro = 1 to 4 employees, small = 5 to 14 employees, medium = 15 to 49 employees)
9 African Economic Outlook 2004, AfDB/OECD.
The introduction of new banking laws in June 2003 has not yet resulted in a significant increase in competitiveness. The banking sector is dominated by the four state-owned banks, which account for half of the sector’s activities.

The Egyptian financial sector is liquid, however this is not because of a high domestic savings rate, which is significantly lower than in other lower middle income countries. Rather, there is a general reluctance by banks to lend in the uncertain conditions that have pertained over the past several years\textsuperscript{10}, while at the same time there is a lack of investment opportunities in productive sectors and financial outlets for savings remain embryonic\textsuperscript{11}.

The attention of the financial sector has, until relatively recently, been focused on the larger end of the market. Over the past few years, however, decreasing margins in mid- and large-cap lending have heightened financial institutions’ interest in tapping the unmet demand for financial services for small business. The pressure of NPLs in their traditional corporate portfolios, together with reducing retail opportunities (due to a prolonged economic downturn and a reduction in the middle class market), have added to this trend. Many banks have recently become increasingly serious about penetrating the (what is to them) new market represented by the SME sector; some have even started lending to micro-enterprises. According to CGC Consult, the management of some banks are realising that the risk of lending to SMEs can be effectively managed and that SMEs represent a profitable market.

The Government of Egypt started its policy of supporting SMEs in about 1990. A Draft National Policy Framework for SME Development is currently under review. Once fully updated, this will serve as a general framework and a reference for policies and development efforts targeting SMEs. The Government outlined its vision in a document titled "Egypt in the 21st Century: Vision 2017" in which it set out a number of targets including the creation of more than 550,000 employment opportunities each year through 2017. A considerable portion of those jobs will have to be provided by viable small businesses: if SMEs continue to provide a large share of total employment, SMEs will provide about 325,000 of these jobs per year. For this reason, the new government, in power at the time of the country visit for only two months, is eager to increase the level of support to SMEs.

A multi-donor fund, the Social Fund for Development (SFD), created in 1992, provides funding for micro and SMEs, communities and redundant workers of state owned enterprises. Loans at subsidised rates are provided through banks and NGOs. Currently the SFD totals about US$1,656 million equivalent from 21 international donors\textsuperscript{12}.

While no credit bureau currently exists in Egypt, one is reportedly in the planning stage that will reach to quite small loan amounts.

Egypt does not compare particularly favourably with the region in its enabling environment for business.\textsuperscript{13} It takes 13 transactions (regional average 10, OECD average 6) and 43 days (regional average 39, OECD average 25) to start a business in 2004. Cost of starting a business as a proportion of gross national income per capita is 63 percent (regional average 51 percent, OECD average 8

\textsuperscript{10} African Economic Outlook 2004, AfDB/OECD.
\textsuperscript{11} USAID Egypt.
\textsuperscript{12} Social Fund for Development website.
\textsuperscript{13} Doing Business – Snapshot of Business Environment, World Bank / IFC
percent). It takes 55 procedures (regional average 38, OECD average 19) and 410 days (regional average 437, OECD average 229) to enforce a contract, from the time a plaintiff files a lawsuit to the time of actual payment. The cost is 18.4 percent (regional average 17.9 percent, OECD average 10.8 percent) of the debt. It takes 4.2 years (regional average 3.9, OECD average 1.7) and 18 percent of the estate (regional average 13.0 percent, OECD average 6.8 percent) to resolve bankruptcies, resulting in a recovery of 18.4 percent (regional average 28.6 percent, OECD average 72.1 percent).

Measures on credit information sharing and the legal rights of borrowers and lenders show a somewhat similar pattern. One set of indicators measuring how well collateral and bankruptcy laws facilitate lending ranges from 0 to 10, with higher scores indicating laws better designed to expand access to credit. Egypt has a score of 0 (regional average 3.9, OECD average 6.3). A Credit Information Index measuring the scope, access and quality of credit information available through public registries or private bureaus ranges from 0-6, with higher values indicating that more credit information is available from a public registry or private bureau. Egypt has a score of 3 (regional average 2.1, OECD average 5.0).

In terms of the study thesis and macro factors for success and failure, Egypt scores slightly worse than average on the factors identified, as shown in Table 1.

### Table 3 Assessment of Enabling Environment against Factors for Success

<table>
<thead>
<tr>
<th>Factors for Success</th>
<th>Factors for Failure</th>
<th>Assessment</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>1   2   3   4</td>
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<tr>
<td><strong>Macro Factors</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1 an open, competitive banking environment wherein there are a number of independent banks, a majority of which are interested in expanding their client base, establishing niche markets, or protecting market position;</td>
<td>• a thin banking sector that is controlled by a few powerful vested interests, in which banks are sufficiently profitable with their existing, limited clientele to support the financial and/or political ambitions of those controlling interests;</td>
<td>![ ]</td>
</tr>
<tr>
<td>2 a monetary and regulatory environment that is conducive to lending to SMEs, in particular with sufficient liquidity and stable interest rates that allow for appropriate risk/return pricing;</td>
<td>• restricted liquidity for SME lending and/or excessive interest rate risk that discourages opening up new markets;</td>
<td>![ ]</td>
</tr>
<tr>
<td>3 a dynamic and/or expanding business sector within which viable opportunities are available for exploitation by new entrants including MSMEs;</td>
<td>• a thin business sector that is not under pressure to change or reform, in particular to become more inclusive;</td>
<td>![ ]</td>
</tr>
<tr>
<td>4 a framework for business (political, policy, legal, regulatory and social) that, in its application as well as its theory, is supportive of enterprise in all its forms including MSMEs.</td>
<td>• endemic corruption and/or incompetence that distorts and/or restricts the operation of market forces and discourages MSMEs from entering the formal economy.</td>
<td>![ ]</td>
</tr>
</tbody>
</table>

Where 1 = “very much so”; 2 = “to some extent”; 3 = “only slightly”; 4 = “not at all”.
Credit Guarantee Company for Small and Medium Enterprises (CGC)

CGC was established in 1989 as a private joint stock company as a result of cooperation between the Ministry of International Cooperation and USAID. The founding shareholders were nine Egyptian banks and one insurance company, and initial capital was LE 5 million. CGC started operations in 1991. Its mission was to encourage financial institutions to deal with Small and Medium Enterprises by providing different and suitable guarantee schemes. Support for micro enterprises was subsequently added to CGC’s mission. CGC has four branches, in Alexandria, Tanta, Assiut and Menia, in addition to the head office in Cairo. Its activities now cover all of Egypt’s 26 governorates.

CGC operates several funds which are capitalised from different sources, including the Government of Egypt, USAID and Italian Aid. The company manages each fund separately. Each fund is owned and managed by the company, an arrangement that CGC insists upon so that it can manage risk through a very conservative investment policy, agreed with the funding agency. Each fund has its own objectives (development as well as financial), strategy and expected outputs, including benchmarks set in agreement with the funding agency. Each fund is accounted for as an independent profit centre.

Currently, CGC operates four funds:

- the SME Fund, funded by the Government of Egypt under two agreements, the first for a soft loan for LE60 million with a grace period of 10 years, which was received in 1991, and the second in the form of trust fund of LE 60 million granted to CGC by the Government of Egypt in April 2003, of which LE20 million was received in July 2003.
- the Health Care Providers Programme (HCPP), originally funded by USAID in 1991 as a trust fund in the amount of LE33.9 million (equivalent to USD10 million at that time).
- the Small and Emerging Business (SEB) Support Programmes (USAID), funded for the LE equivalent of USD8.2 million, of which USD2 million equivalent was received in two tranches (LE3.5 million in July 2000 and LE6.19 million in August 2004).
- the Poverty Alleviation and Employment Generation programme, funded by the Italian government (LE2.7 million) in 1998.

Since inception until the end of 2003, CGC through its four projects has been able to serve 29,694 enterprises to access credit of around LE2.5 billion. The average cumulative repayment ratio for all four projects is 97 percent.

The commercial relationship is between CGC and the lending banks. The flow of business is from the banks to CGC, with banks selecting which loans they wish to be

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15 In September 2004, the exchange rate was approximately LE 6.2 = USD 1, and LE11 = UKL1
16 As of 31 December 2003, four annual instalments had been repaid, reducing the loan balance to LE54 million.
17 Prudent investment management by CGC has resulted in a fund of LE77.9 million at the end of 2003.
guaranteed. Entrepreneurs who approach CGC directly are referred to partner banks. Risk appraisal is done by the bank but is checked by CGC, and some banks have commented that this brings added value to CGC’s service. Because CGC does not take security, the borrower has no direct relationship with the guarantor.

Innovation has been a constant throughout CGC’s history. This can be seen in the way it has changed its approach to guarantee operations. In the first phase of operations, banks did not understand the concept of a credit guarantee and did not appreciate the role of CGC or the justification for the fees charged. Problems were experienced because, in some cases, CGC refused to pay called guarantees because the bank had not satisfied its obligations under its contract with CGC. As a result of such experiences, CGC has changed the nature of its relationship with its partner banks several times.

From 1991 to 1997, the fund operated exclusively as a classical guarantee fund, sharing the risk of default on individual eligible loans in return for a guarantee premium. Since 1997, the HCPP Fund has also included guarantees of the bank overdrafts of NGOs lending to health professionals. This has been also the case in the Italian (1998) and SEB (2000) projects lending to micro and small entrepreneurs. It is continuing this trend by moving into guaranteeing bank portfolios. A Memorandum of Understanding has been signed with the Industrial Modernization Program guaranteeing bank portfolios for a specific industrial program. The Swiss Development Agency is currently examining the possibility of signing an agreement with CGC that may involve guarantee for leasing companies. CGC now makes arrangements largely on the basis of guarantee of a loan portfolio or of an NGO overdraft. It has also recently made proposals to banks to manage a guaranteed loan portfolio on an outsourcing basis, for a management fee.

Some of this relentless innovation is no doubt due to CGC Consult. In 1998, in cooperation with the private consulting company FINBI\(^\text{18}\), CGC established this independent technical arm to assist with business development, training of CGC and bank staff, evaluation and follow up, and development of new models for guarantee business. CGC Consult, with a staff of 11, is owned 20 percent by CGC and 80 percent by FINBI, meaning that CGC Consult is not controlled by CGC but is highly motivated to produce results that justify fees charged. CGC Consult is free to provide credit guarantee consulting services to other companies as well as to CGC.

Most recently, CGC is implementing a restructuring plan in 2004-2005, including an integrated MIS that will cover all aspects and functions of the company and allow for future expansion, including credit scoring and comprehensive monitoring and evaluation of company performance. CGC has high hopes for the restructuring, and expects it to have a noticeable impact on the performance on all levels of the organisation from middle management to the executive level. The MIS will facilitate improved short and long term planning and decision making and execution of operational and coordination functions, through detailed financial analysis and reporting, comparison reporting, and the ability to handle multiple branches and currencies. Some resistance to change has been experienced, however CGC management and CGC Consult feel that continued reform is required to ensure the success of CGC in future.

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18 The founder for FINBI conducted the original study funded by USAID in Egypt on guarantees which led to the founding of CGC.
**SME Fund**

CGC currently defines an SME as a legal enterprise with total investment between LE40,000 and LE10 million, excluding the value of land and buildings. The fund will support loans from LE20,000 to LE1.4 million financing working capital or fixed assets, in all economic sectors. It guarantees a maximum of 50 percent of the approved principal amount (accrued interest is not guaranteed). Loan terms range from 6 months to 5 years, and are subject to extension on the partner bank’s request. No collateral is taken by CGC, which charges an annual administrative fee amounting to 2 percent of the value of the amount guaranteed.

The guarantee is subject to terms and conditions with which the partner bank must comply. These include regular reporting from the borrower to the bank and the bank to CGC. Guarantees are reviewed annually and if these terms and conditions are not complied with, the guarantee can be cancelled by CGC. This has been done in the past and has led to some relationship difficulties with partner banks.

The SME project served 12,489 enterprises, facilitating access to credit of LE1.9 billion through issued guarantees of LE805 million by the end of 2003. The average loan amount was LE156,000 and the average guarantee LE 64,000. The majority of the loans were for working capital - approximately 68 percent by number and 74 percent by loan value. CGC estimates that it has generated approximately 97,000 job opportunities through its SME financing operations. The cumulative overall repayment ratio by end of 2003 was 97.28 percent. Losses ("liquidated guarantees") net of recoveries have totalled LE11.6 million since inception until the end of 2003, representing 1.44 percent of guarantees issued.

At the end of 2003, outstanding guarantees of the SME fund were LE154.3 million (2002, LE146.5 million). By end of the second quarter of 2004 the outstanding guarantees was LE181.6 million, representing a multiplier of approximately 2.2. From inception to the end of the second quarter of 2004, the SME Fund issued 13,492 guarantees totalling LE873.2 million, supporting loans of LE2,113.8 million. The average loan size was LE156,670, supported by an average guarantee of LE64,720 (41.3 percent).

By end of the second half of 2004, industrial sector SMEs make up the bulk of the guarantees, with the cumulative average running at approximately 55 percent of total guarantees. Contracting is next with just under 19 percent, followed by agriculture (8.7 percent) and services (6.6 percent). Guarantee operations for trade sector SMEs has just recently been introduced, accounting for its low share of total guarantees issued to date (1.8 percent).

Of the 34 banks that has entered into a contract with CGC, 25 have issued guaranteed loans to SMEs. These fall into two distinct groups, with the top three banks accounting for 83 percent of guarantees by value. A further two banks account for a significant number of guarantees by number but not by value. The remaining 20 banks altogether account for 10 percent of guarantees by value.

**Health Care Providers Programme**

For this programme, financed by USAID, CGC guarantees 100 percent of loans up to LE100,000, and 65 to 75 percent of loans in excess of this amount (maximum
guarantee is LE700,000). Loans, which have a repayment period of 5 to 7 years, are provided by CGC’s partner banks and NGOs specialised in this type of lending.

CGC charges an annual administrative fee of 2 percent of the value of the amount guaranteed in case of direct credit to clients and an annual administrative fee of 2 percent of the highest debit balance of each NGO overdraft account in case of lending through NGOs.

The target group including physicians, dentists, veterinarians, pharmacists and medical establishments such as laboratories and clinics. CGC also provides training to borrowers to enable them to manage their financial affairs. CGC considers the training provided to be integral to the success of the programme.

The original agreement with USAID was signed in 1991. Three extensions since that date have incorporated changes to mechanisms, such as including NGOs as lenders, to enable the programme to respond to market needs. Currently, CGC is examining a further innovation, to use leasing for provision of medical equipment to health professionals.

From 1991 to end of 2003, CGC through its HCPP project had served 11,040 enterprises, allowing them to access credit of LE645 million through issued guarantees of LE538 million. The average loan amount was around LE58,000 and the average guarantee was LE49,000. The majority of the guarantees were for developing existing medical projects (88 percent). CGC cumulative overall repayment ratio by end of 2003 was 97.53 percent.

As at year end 2003, outstanding guarantees under this programme had reached LE118.4 million to 3,517 beneficiaries, indicating a multiplier of approximately 1.5 against trust funds available of LE78.0 million. The programme had benefited 11,487 medical professionals with guarantees of LE562.6 million by the end of the second quarter 2004, supporting loans of LE672.9 million. The majority of loans were to pharmacologists (about 40 percent by number and loan amount), but covered a broad range of specialisms. The average loan size was LE58,580, supported by an average guarantee amount of LE48,980 (83 percent). In the first two quarters of 2004, 78 percent of guarantees were to male and 22 percent to female borrowers. The loan repayment ratio for this portfolio was reported to be 97.53 percent, cumulative since inception to year end 2003. Liquidated guarantees net of recoveries totalled LE5.6 million from inception up to the end of the first half of 2004, representing 1.0 percent of guarantees issued.

Small and Emerging Businesses Programme

The USAID funded SEB Programme was established as a trust fund equivalent to USD8.2 million, plus up to LE1.375 million to cover operational expenses and start-up costs of each of the involved units plus a further LE3.6 million as capitalisation upon each unit's breakeven. The programme is being implemented through NGOs under contract to CGC to provide small and micro and group-focused micro-loan services to micro and small enterprises.

scheduled to be 30 units by the end of the third year of operation.
For group lending, eligible loans are those from LE50 to LE500 (from LE500 to LE1000, the unit has to refer individual cases to CGC); for micro loans, eligible loans are from LE1,000 to LE3,000; and for small loans from LE3,000 to LE 25,000.

Within this program, CGC is responsible for: selecting the NGOs; ensuring the extension of the project to all governorates of the country; and building the institutional capacity of the units through providing needed technical assistance with the assistance of a TA adviser appointed by USAID and CGC. CGC is also responsible for monitoring the NGOs and ensuring their compliance with the pre-set plan and projections, assisting them to achieve break-even, and ensuring that they have sufficient capacity to graduate from the project.

CGC provides a 100 percent guarantee of the NGO overdraft with its bank. CGC has an ambitious schedule to establish 30 SEB units in 3 years with credit increasing rapidly to reach LE135 million by year 3. A special unit within CGC has been established to manage the program, which is expected to achieve financial sustainability. CGC expects the SEB programme to achieve a multiplier of 3 in third year of operation.

CGC charges a guarantee fee of 2 percent on the highest debit balance of the SEB units’ overdrafts for small and micro clients, while for group lending CGC charges a 3 percent guarantee fee on the highest debit balance of the overdraft account.

From 2000 to the end of 2003, the SEB project has been able to help 4,098 enterprises to access credit of LE11.5 million, despite very conservative operational results caused by delays in finalising the complementing agreements with USAID. The average loan size was LE2,800. CGC estimates that it has generated approximately 5,228 jobs from the beginning of the project’s operation to the end of 2003. The cumulative repayment ratio by end of 2003 was 98.6 percent.

**Poverty Alleviation and Employment Generation Programme**

This programme, financed by a trust from of LE2.6 million from the Italian government, aims to raise the living standard of micro entrepreneurs in Giza governorate through increasing their incomes. CGC expects to replicate the programme in other governorates. The target group includes micro and small enterprises in any sector except agriculture and livestock. Eligible loans are from LE5,000 to LE40,000, for working capital (repayment period up to 18 months). Again, CGC guarantees 100 percent of the NGO’s overdraft with its bank.

From 1999 to the end of 2003, through its Italian project CGC has served 2067 enterprises, enabling them to access credit of LE26.2 million. The average loan amount has been LE13,000. The program has been able to generate around 11,925 job opportunities since its inception. The cumulative repayment ratio for the project was 94.21 percent by the end of 2003.

**Institutional Framework**

CGC is a company with a Board of Directors of 12 members, headed by a Chairman who is also the Managing Director. The Ministry of International Cooperation is also represented on the Board.
Financial sustainability is a declared goal of CGC, which produced small profits in 2002 and 2003. Each fund is accounted for as a separate profit centre, and any excess after provisions is often added to fund capital.

The current level of provisions is approximately 4.9 percent of the outstanding guarantee portfolio. The fund paid out claims against individual loans at the rate of 0.9 percent of the total amount of guarantees issued 1991-2003.

Findings

Assessment of the CGS

Design Philosophy and Strategic Approach

Most original shareholder banks, when questioned as to why they contributed initial capital to CGC, state that they were convinced by the business case for the guarantee service. Competition in the existing bank markets, increasing globalisation, ongoing privatisation of state-owned enterprises and liberalisation of interest rates were all factors in the decision of those banks that considered the initiative from a commercial perspective. In general, however, it appears that CGC was seen as a commercial project by the banks, a strategic opportunity supported by the prevailing trend toward increased government and donor support for, and likely resulting growth of, the SME sector.

However, most banks also stated that they wanted to support the country’s development programme and one participated only to comply with the Government’s social initiative, so a commercial approach was not universal. On the other hand, not all government owned banks participated in the initial capital of CGC, so it is clear that participation was not required.

Some banks remain uninterested in CGC’s offering. Those that are interested tend to be those that wish to diversify their risk by opening up a new target market. Some newer partner banks have used CGC’s guarantee services much more than some founding shareholders. This perhaps indicates that subscription to the original call for support may not have been based solely on an understanding of, appreciation for, and intention to use the guarantee services, but it also indicates that the partner banks have used the services based on their perception of its relevance to their business targets and its usefulness in achieving those targets. Some banks that are founding shareholders focused, and continue to focus, on target markets other than the SME sector, and these tend to use the guarantee services of CGC less than those that target the SME sector as part of their marketing strategy.

All the banks interviewed regard the SME sector as an important and profitable segment of the market, although some had made the decision not to target the SME sector. One bank involved in SME lending stated that it was the most profitable area, considering margins and NPA rates. In comparison, competition in lending to large firms and to the personal sector had driven down returns.

The top five users of CGC guarantee services are all government owned banks. These account for 93 percent by number and 90 percent by value of total cumulative guarantees issued. Partly, this reflects the longer time that these banks have been using CGC’s services. However, state owned banks from this same list are the top three users of CGC guarantees in the first half of 2004, representing 94 percent by...
number and 90 percent by value of total guarantees issued in that period. It would appear that CGC has been unsuccessful in expanding the attractiveness and use of its traditional SME guarantee product to clients outside the original group of state owned banks.

CGC recognises the importance played by senior bank managers, as in the first factor, “an influential champion within the lenders”. Subsequently, CGC has taken care to preserve these relations, although in at least one case, business relations have been derailed because of the souring of the personal relationship with the champion within the partner bank.

The approach of CGC reflects the second, third and fourth success factors of our thesis. It has taken the “financial sector approach” from the start of its existence; it has an understanding and empathy with market forces, and it has a long term approach emphasising institutional and financial stability. This has only improved over the years, as new models for guaranteeing SME lending operations have been developed. There is evidence that CGC still suffers from excessive bureaucracy, at least with respect to its traditional credit guarantee operations, but an upcoming company restructuring is expected to improve this.

While CGC served as the pioneer for SME credit guarantees in the early 1990s, the concept is relatively well known and understood today and this role has diminished. There is no real evidence of extensive current transfer of appropriate SME lending technology to banks, as in our fifth factor for success. Such technology transfer is more apparent in CGC’s microfinance activities, where CGC guarantees the bank overdrafts of partner NGOs that are still learning how to lend to micro enterprises.

The institutional arrangements allow the shareholder banks a consultative or directive role only through their representation on the Board. This is in line with the sixth success factor of the study thesis. However, those banks that are not shareholders (which now makes up the majority of CGC’s partner banks) do not have formal input into decision-making at CGC.

CGC regards the banks as its primary clients, and sees itself as delivering a product to them which assists them in their commercial operations. At the start of its operations, CGC also provided a marketing service aimed at potential borrowers, thus helping partner banks to develop their client outreach. A common comment of partner banks was that this effort had reduced in its intensity and effectiveness and they would like to see it renewed.

CGC provides support to banks in training front line bankers in the use of the guarantee system. However, none of the partner banks interviewed cited it as a benefit to their relationship with CGC. One bank also remarked that the recommendation of CGC with respect to an individual applicant was taken very seriously as input to the final lending decision, and that this was clearly perceived within the bank as value added. In addition, CGC actively promotes the sectors related to its funds through a wide variety of meetings, seminars, workshops and promotional events. Seminars for banks and policy makers help promote understanding of the SME sector.

CGC does not take any collateral security and takes no view on whether its partner banks take additional security or not. The banks vary widely in their approach to this issue, with some using the CGC guarantee alone and others taking at least some
additional security. Taking collateral involves extra costs and delays for both bank and borrower and indicates a continuing need on the part of the bank to strive for full security coverage of the loan. Those banks that do not require additional security indicated that they believed the cost of taking and, in particular, realising additional security outweighed any additional value it might provide. However, it may be that some collateral should in principle be taken from borrowers to ensure that they suffer loss in the case of business failure, to guard against moral hazard.

Those banks most active in the SME sector stated that, without CGC guarantees, lending to the SME sector would decrease; estimates varied from 50 to 80 percent.

**Negative Evidence**

None of the banks interviewed cited any negative effects from CGC operations. Our observations indicated that the conditions attached to the scheme had not resulted in any distortions in the market place.

**Summary**

The assessment of CGC against our micro factors for success and failure is set out in Table 4.

**Table 4 Assessment of CGC against Factors for Success**

<table>
<thead>
<tr>
<th>Factors for Success</th>
<th>Factors for Failure</th>
<th>Assessment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Micro Factors</td>
<td></td>
<td>1 2 3 4</td>
</tr>
<tr>
<td>1 an influential “champion” (or champions) within the lender(s) who actively promotes the CGS for appropriate commercial reasons;</td>
<td>lack of support or lack of understanding of the commercial logic of the CGS within the lender(s);</td>
<td>√</td>
</tr>
<tr>
<td>2 a “financial sector” approach to CGS design that focuses on the goal of achieving a permanent deepening of the financial sector;</td>
<td>a “social sector” approach that focuses exclusively on a short-term goal of pushing finance to the SME sector and the use of financial institutions as conduits for that purpose;</td>
<td>√</td>
</tr>
<tr>
<td>3 an understanding of and empathy with market forces, particularly for providers of financial intermediation services;</td>
<td>an emphasis on the social obligation of lenders or compliance with laws, regulations or policies</td>
<td>√</td>
</tr>
<tr>
<td>4 a long-term approach that emphasises institutional and financial sustainability, with objectives directly related to financial sector deepening, even if project interventions are short or medium term in duration;</td>
<td>a project approach that focuses on short-term objectives that are limited to the period of the project intervention, rather than directly related to long-term financial sector deepening;</td>
<td>√</td>
</tr>
<tr>
<td>5 extensive transfer of appropriate lending “technology” in terms of policies, procedures, methodologies and systems through carefully</td>
<td>reliance on targets for achievement of project lending objectives without regard for the ongoing sustainability of</td>
<td>√</td>
</tr>
</tbody>
</table>

Where 1 = "very much so"; 2 = "to some extent"; 3 = "only slightly"; 4 = "not at all".
Factors for Success | Factors for Failure | Assessment
---|---|---
Focused technical assistance; institutional processes; |  | 
6. A participative approach that achieves a balanced partnership between donors, CGS and lenders for achievement of agreed objectives; | A paternalistic approach that imposes a CGS project on reluctant lenders who do not understand or do not agree with the stated objectives; | ✗

7. Ownership by lenders of the CGS stemming from clear and significant benefits to lenders in terms of assistance to open up new markets for profitable commercial exploitation. | Coercion of lenders through a “carrot” (non-transparent benefits unrelated to financial sector deepening) and/or “stick” (pressure from political or regulatory authorities) approach.” | ✗

Overall Financial Deepening Performance and Impact

CGC is a success from many perspectives. It took a pioneering role in establishing SME lending in Egypt, at the same time achieving profitable operations under an independent company structure. Since then, it has implemented continual innovation in operating models, moving away from the classical model toward guaranteeing portfolios and lenders’ overdrafts, and is now discussing with banks operating SME lending operations on their behalf. It has also started to address the needs of the micro enterprise sector through products and delivery mechanisms adapted to their needs, the potential demand for which is enormous.

The potential size of the market and the proportion of SMEs being served by formal financial institutions have been difficult to gauge because the banks interviewed were not prepared to discuss the size and character of their non-guaranteed SME portfolios, and the data available is not sufficiently disaggregated to be useful. However, it appears that, in general, banks are unwilling to lend to SMEs without the support of CGC or SFD.

The approximately 3,000 guarantee transactions per year that CGC conducts under its SME and HCP Programmes, after 13 years of operation, represent only about 3 percent of the 116,305 small and medium enterprises identified in the 1996 CAPMAS census of business enterprises. The number of SMEs has undoubtedly grown since the time of the census. While not all SMEs may be borrowers, either formal or informal, it is clear that CGC has not managed to achieve significant outreach to the SME sector, at least in terms of its direct guarantee operations. As a result, we conclude that the extent of the direct impact of CGC operations on financial sector deepening has been marginal.

The constraint to significant expansion of outreach appears to be demand. It appears that the main source of funds for SME lending through formal financial institutions is the Social Fund for Development rather than deposits. This massive programme provides funds at subsidised rates, with interest rates on loans ranging from 7.0 percent for a new enterprise requesting a loan less than LE50,000, to 13.0 percent for an existing enterprise requesting a loan between LE200,000 and LE500,000. SFD has also contributed to establishing the Cooperative Insurance Society for Small Enterprises (CIS), which provides guarantees for applicants that have difficulty meeting collateral requirements. CIS guarantees are available up to 90 percent of an
enterprise’s value, to a maximum of LE200,000. In addition, SFD sponsors local and international marketing exhibitions and operates business incubators.

The competition to CGC from the SFD is probably sufficient to limit the market for CGC's products. In addition, the regressive nature of the SFD services, particularly the subsidised interest rates offered, will have a crowding-out effect for market-driven services such as those of CGC. The banks have apparently picked up on the coddling attitude of government toward SMEs: in many cases they appear to be unwilling to lend to SMEs without support either from CGC or SFD, despite losses that should be well within their tolerance. (CGC liquidated guarantees net of recoveries have totalled LE12.5 million since inception, representing 1.43 percent of guarantees issued).

Despite this, there is evidence that CGC has promoted financial sector deepening, albeit on a small scale relative to the economy. The awareness of CGC within its existing client base is high, its product delivery is trusted and its commercial value is reported to be high for those banks that target those sectors supported by one of CGC’s funds. CGC has been innovative in extending its coverage to health and micro enterprises as well as SMEs. This has been at least partly in response to donor and government initiatives and available of external funding, however it has also been as a result of the institutionalised agent for innovation represented by CGC Consult. From a situation of very little available finance for SMEs at the start of operations, CGC has encouraged its clients to enter this sector to the point where some of its most active partner banks are lending to the sector with only the partial collateral security coverage provided by the CGC guarantee.

There is no doubt that the CGC guarantee facilitates the access to finance of Egyptian SMEs. For banks, the CGC guarantee represents a competitive tool that allows them to lend more and to expand market share in this market segment, particularly with respect to businesses new to their bank or new to the banking system. It also helps to reduce the cost of lending below what would be possible if other, more expensive and less realisable collateral were taken. Banks that have made a strategic decision to target the SME sector have made various degrees of adaptation to their organisation to accommodate the special needs of SMEs. Some have opened specialist SME departments with loan officers dedicated to SME lending. Most of these banks credit CGC with introducing them to SME lending, helping them promote their services to the sector, and facilitating their outreach. Even CGC partner banks that do not primarily target the SME sector were predicting growth of around 10 percent per annum in their lending to the SME sector in the coming few years.

The recent economic downturn, which has been particularly long-lasting, has undoubtedly delayed the move by banks into SME sector lending and has even led to a downward trend in lending to SMEs in some banks. In particular, the newer partner banks appear to be taking up CGC guarantee services at a very slow rate.

The degree of financial sector deepening can be expected to increase over the coming years as the Egyptian economy recovers from its prolonged economic downturn, enters more fully into the global economy, and increasingly relies on the SME sector for GDP and employment growth. Competitive pressures and the feedback of information on the low level of risk shown by the guaranteed portfolio will be the drivers for banks to increasingly target the SME sector.
The likelihood of increased indirect deepening is perhaps most clearly demonstrated by the case of Bank du Caire (BdC). Because of problems with large clients, BdC sought increased value added from its large branch network through targeting micro and small enterprises.

BdC signed a Memorandum of Understanding with CGC in 2001 for provision of a guarantee for up to 100 percent of BdC’s micro-credit portfolio in the first and second year, decreasing gradually to 50 percent in the fourth year. A unique mechanism was agreed to deal with defaults at the branch level as well as at the level of the overall micro-loan portfolio of the bank. However, negotiations were protracted and BdC decided to start lending without the guarantee in place. BdC has now decided to do without a guarantee to support this portfolio, given the good repayment performance experienced.

BdC’s performance was originally forecast to reach a portfolio of LE512.7 million after three years of operation, and this served as the basis for the original MoU with CGC. On the request of BdC, a more conservative projection was developed forecasting a portfolio of LE366 million after three years. This reduced forecast has not been achieved: the bank’s current portfolio is approximately LE133 million. It is interesting to speculate whether BdC would now be lending to micro enterprises, without a supporting guarantee, had CGC not paved the way by guaranteeing similar operations in other banks and, through the potential availability of the guarantee, encouraging BdC to consider such lending in the first instance. It is also interesting to speculate whether their BdC’s micro-loan portfolio would now be larger if the cooperation envisaged with CGC had gone forward.

**Suggestions for Improvement**

When asked for suggestions for improvement, the banks interviewed focused on suggestions for increased marketing activity by CGC. Generally they seemed to feel that CGC was not doing as much as it used to, or should, to promote its partner banks’ SME business growth. This is an area that CGC might like to consider ramping up in future.

CGC does not appear to have considered the value to its partner banks of the high quality information about the actual risk of lending in the sub-sector covered by its guarantees. This is often cited as a major benefit of entering into a partnership agreement with CGS in other countries. If detailed results for the whole portfolio of guaranteed loans, analysed by bank, were distributed each month to its partner banks, CGC would be providing a benefit that is not available from any other source and would assist banks with their management of this portfolio. If it were possible to make the results transparent to all partner banks, it might serve as a spur to competition between them. The greater the transparency, the higher the likely competitive-inducing effect would be.

Overall, CGC needs to take advantage of any upturn in the economy to rapidly increase its scale of operations to achieve greater financial sector deepening impact. In particular, a focus on ramping up operations with the newer partner banks seems to have potential for achieving good results, given the current low level of activity.
Executive Summary

The Study

This case study of India forms part of the 2004 research effort mounted by the Financial Sector Team at the Policy Division of DFID into the role of credit guarantee schemes in financial deepening\(^1\). The research aims to shed light on the factors and circumstances determining the degree, if any, of financial deepening that results from the operations of credit guarantee schemes (CGS), working with banks who are lending to SMEs.

We found it useful terminology to distinguish between direct deepening, which refers to effects linked directly to the current use of guarantee products by the banks, from indirect deepening which refers to broader effects on bank behaviour brought about by their experience of guarantee usage.

The CGS called CGTSI in India was chosen as one of the four case studies because there was prima facie evidence from preliminary desk research that it was a new scheme dating from the year 2000, which had benefited from the previous experience (good and bad) of the old CGS run for many years by the DICGC (Deposit Insurance and Credit Guarantee Corporation) that it was using modern technology and a simplified but highly professional management approach to relaunch the credit guarantee product in a very large market, and that it had powerful backing in terms of the scale of resources announced to be available for its fund.

The research method consisted of personal interviews with the management team of the CGS and with a selection of their participating banks, using structured questionnaires as the basis of discussions. The bank selection was designed to provide examples of heavy and light users of the CGS, and of private as well as public sector banks.

In practice, the Enterplan consultant was based in the CGTSI offices for the field visit\(^2\), and had opportunities for extensive discussions with members of the management team beyond the formal interview. A total of 5 banks were formally interviewed, four public sector and one private.

Key Findings

Evidence for Direct Deepening

The evidence suggests that, so far, only very limited financial sector deepening of the direct kind has occurred.

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\(^1\) The opinions expressed in this Case Study are those of the consultants and do not necessarily reflect the opinion of the UK Department for International Development or the official policy of the UK Government.

Appendix A7 – Case Study - India – Executive Summary

- The penetration of CGTSI is so far very low at a cumulative 18,000 transactions, after nearly 4 years, against a target population of 2.3 million registered and 9 million unregistered target firms.

- There have been four active banks (over 1,000 transactions each) accounting for 78 percent of the number among the 29 who have so far used guarantees. These banks have so far concentrated on using the guarantee in the smallest loan size range, under Rs 0.5 million (approximately USD 11,000), where there is a standing central bank instruction to make loans collateral free. Average loan size for all transactions to June 2004 was approximately Rs 0.164 million (USD 3,650).

- Only 6.9 percent of all guarantee approvals to March 2004, that is just over 1,000 transactions, were for loans above Rs 0.5 million. The overall average amount guaranteed increased, however, by 43 percent in the 15 months to June 2004, and the trend to larger loans is accelerating.

- Banks interviewed generally cited the CGS as a tool which would enable them to expand their lending to new borrowers, including first generation entrepreneurs, but there was no data to support this attribution.

- Two public sector banks out of four interviewed recognised the CGTSI as having a clear advantage in principle over collateral, but were concerned about borrower resistance to guarantee fees, particularly those charged in the first year.

- The private sector bank saw the CGTSI as an essential tool to attack a small part of a specific market sub-segment, which it would not otherwise be able to address.

Upwards of 1,500 front line bankers had been trained in the use of the guarantee to service small enterprises, which, in the absence of collateral, might not otherwise have had access to loans.

**Indirect Deepening**

So far there was no hard evidence, or support from interviews, that banks’ non-guaranteed SME lending operations had been affected by their experience with guaranteed lending.

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3 Approx figure at end August 2004
4 30 June 2004
5 From Rs. 0.115 million to Rs. 0.164 million loan size
Case Study – India

Introduction to India

India is an economy of 1.1 billion people, with a GDP of USD 547 billion in 2003. The movement towards a more open market economy, begun in the early 1990s, and given extra impetus with the 1999 change of government, has been accompanied by an average growth rate of more than 6 percent per annum for more than a decade. In the year to March 2005, the forecast is for growth of 6.4 percent, down from the previous year’s 8.1 percent. However, to absorb the numbers or people joining the workforce each year, the required growth rate has been calculated at 10 percent. Economic fluctuations are still quite dependent on monsoon-related agricultural performance. Moreover, the poorest Indian states have yet to benefit much from the recent growth period, and the economy is vulnerable to high oil prices.

The IMD’s\textsuperscript{6} world competitiveness index in its 2004 edition gave India a sharply improved ranking from the previous year up from 50th out of 60 to 34th. The sources were improvements in the areas of economic performance, business efficiency and to a smaller extent in government efficiency. Infrastructure remained a weak aspect.

International trade is not yet a very strong feature of the Indian economy, although the export percentage of GDP has been rising sharply in recent years and was 17 percent in 2003, up from 9 percent in 1992, with software a strong performer.

The official designation of the SME sector in India is traditionally “Small Scale Industries” or SSI, and there is a dedicated SSI Ministry, which in practice looks after the interests of the whole SME sector, although sub-sectoral definitions are important for programme eligibilities. The SSI sector, which covers manufacturing firms with investments in plant and equipment up to Rs 10 million (approx. USD 220,000) is responsible for 40 percent of industrial output, and 35 percent of exports, according to official sources.

India’s sovereign rating is BB or BB+, mainly because of high budget deficits and levels of domestic debt. Inflation rates are fairly volatile, peaking at just under 9 percent in early 2001, falling to 4 percent during in 2003, and then rising sharply in 2004 to just over 8 percent in August on the back of strong domestic demand, and higher oil, commodity and food prices. Short term interest rates are more stable, and the benchmark repurchase rate is still 4.59 percent, despite long term rates having moved up sharply from 5.1 percent to 6.6 percent in the last 6 months (10 year government bond yield).

On Transparency International’s 2003 corruption perception index India is ranked low, 83rd out of 133 countries, scoring 2.3 out of a possible 10 points. Historically at least, one contribution to the climate of corruption has been made by some public sector bankers, usually at regional level, who were insufficiently accountable for their lending decisions.

\textsuperscript{6} International Institute for Management Development
Assessment of the Enabling Environment

India, with its 1.1 billion people, is a very large and diverse country, with great disparities of wealth between regions and within regions between urban and rural areas. Its overall GDP per capita, at around USD 550 per annum, is the result of about 35 percent of the population living on USD 1 per day or less, about 60 percent in a middle class able to afford electrical appliances and about 5 percent able to afford a car. India is the world’s largest democracy, and has had regular changes of government including one in 2004. The political and economic institutions are relatively stable and increasingly market oriented, although there remain huge social and infrastructural problems.

The last thirteen years have been a steady period of rapid economic growth in India, and the trend rate is forecast at around 6 percent per annum. The financial sector, including the banking system, has shared in this development and expansion, and has become more competitive and efficient following its substantial liberalisation from strict controls in the 1991 reforms. The real growth of the banking system has been much faster than that of the economy, at nominal rates of 15 to 20 percent per annum, demonstrating a degree of financial deepening.

Banking, however, is still dominated by 27 public sector banks that accounted for approximately 70 percent of assets and liabilities of the sector. Restrictions on foreign ownership of private domestic banks, of which there are 30, have been eased somewhat in recent years. There is a climate to encourage consolidation in both sectors, although within the public sector the 51 percent government holding rule still stands. Within the private sector there have been nine new entrants in the past decade, and they have further stimulated competition in key segments, including parts of the SME sector, by their proactive marketing and high-tech approach. ICICI Bank is the only major privately owned bank, with 7.2 percent of advances in the year to March 2003, second only to the State Bank of India, by far the largest public sector bank. Foreign-owned banks have a small market share of around 7 percent of advances in total, but are also moving beyond their traditional market of foreign companies operating in India to include some large and even medium sized domestic corporations.

In a long established policy of directed lending, all domestic banks have to lend a minimum of 40 percent of their advances to the Priority Sector, which includes agriculture, housing, education, exporters, SSI and small businesses in other sectors. Of this, 18 percent is earmarked for agriculture. Lending to SSI is typically 10 to 15 percent of total advances. Within SSI, banks are encouraged to lend 60 percent to category of the smallest or “tiny” firms. Despite this emphasis, the penetration of institutionalised credit was modest at 14.9 percent of the SSI sector in 2001-2002.

International ratings agencies suggest that the Indian banking system has, over the period since 1991, substantially improved its operational standards, including provisioning, under a supportive but rigorous supervisory regime by the central bank that is now migrating to a risk-based platform with an aim to meet the new Basle Accord by March 2007. Spreads are still high by international norms, however, and costs have further to fall, although computerisation is proceeding quite fast. Also, there is still heavy criticism of the large presence of the public sector, and of some

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Third All-India Census of SSI, quoted in 2004 CGTSI Annual Report.
regulations and risk-weighting rules encouraging banks to place too many resources with government. There is also the legacy of high levels of NPA for some public sector banks. These include large-scale clients as well as many cases in Priority Sector segments. Overall gross NPA of the system was estimated at 9.5 percent of outstanding advances at March 2003, and this may be an understatement because of incomplete adherence to Basle standards of measurement.

The SSI sector has always been highly visible because of special policy attention given to it through the Ministry, with a network of national, regional and local institutions, associations and programmes to support its development. The number of registered and unregistered SSI units was put at 11 million in March 2004, employing 27 million people, making it the largest employment sector after agriculture. The sector has approximately doubled in numbers of enterprises and annual rates of fixed investment since 1991, while the value of production has quadrupled, and exports have multiplied eight-fold. This is a substantially stronger dynamic than that for the industry sector as a whole.

The motive for banks to lend to the Priority Sector, and in particular to SSI, has been gradually shifting away from regulatory compliance, or social lending, towards a search for profit. India’s capital markets are well developed for larger firms to access, so lending margins in that segment are thin. The retail sector demand for credit has slowed. Encouragement to banks to lend profitably to the SSI has come from a recent high-level RBI report\(^8\). Another impetus to be more proactive towards the SSI market has been the coming to an end of a two-year period when market conditions allowed banks to make large profits on their excess liquidity through Treasury operations. Excess liquidity continues, so that there is certainly no shortage of funds for on-lending.

The public sector banks, on the whole and with wide variations, are gradually changing their business model from one of being reactive and paternalistic towards their customers to one of being competitive with each other and pro-active to the market, while extending risk management disciplines to smaller size transactions. This process still has a long way to go. It is beginning to be stimulated in some areas and sectors by the arrival of competition from private sector banks. Multibanking by SSI firms, however, is still rare and is not encouraged by the regulatory or policy framework. Bank switching by SSI firms is also still uncommon.

The public sector banks interviewed regarded the SSI sector as an important and profitable segment of the market. Central bank interest rate ceilings still apply on loans under Rs. 200,000, USD 4,200 but even here the margins are reasonable, although costs are relatively much higher. Exporters of any size also have a rate ceiling, but fee income can be used to compensate. Banks agreed that the SSI sector as a whole was now a high margin, moderate risk area, although legacy NPA rates for the sector were quoted in a range of 10 to 19 percent. Canara Bank, one of the larger public sector banks, and one oriented strongly to smaller business, achieved a growth rate of 28 percent in its SSI advances in the year to March 2004 and has a target of 18 percent for the current financial year. The State Bank of India Group, much the largest public sector bank, announced in June 2004 that its target for disbursements to the SSI sector for the current financial year was Rs15 billion (approx. USD 330 million) compared with Rs 6.5 billion (approx. USD 140 million) in 2003-2004, a huge increase of 131 percent. Overall, the Tenth Plan covering the

\(^8\) A. S. Ganguly, Chairman of the RBI working group on Flow of Funds to the SSI sector, 2003.
period 2002-2007 envisages a 12 percent per annum growth in SSI lending. The private sector bank we interviewed saw opportunities in specific sub-sectors within the SSI market and was designing products to suit them, but had many other priorities.

Credit information and reference sources for the SSI sector, which we have identified as another significant factor in the enabling environment, led by CIBIL (Credit Information Bureau (India) Ltd), which is jointly owned by several banks and Dun & Bradstreet, are improving, although not yet good in large urban areas. CGTSI hopes to contribute information in the future to the CIBIL databases.

One aspect of the environment for small business lending that is perhaps less favourable is the mixed signal conveyed by the continuing presence of RBI in its role as issuer of specific and detailed guidelines to banks as to how they should conduct their business with enterprises in this segment, including detailed instructions on when collateral requirements can or should be relaxed. This administrative approach tends to reinforce the older tradition of the banks as a channel for social lending and is at variance with RBI’s other line, in which banks are being encouraged to address the SME sector as a profitable market segment. The CGTSI scheme itself, as discussed in the next section, is right in the centre of this slightly confused approach.

In the Indian context, another aspect of lending culture in the public sector banks is relevant here. Traditionally, in cases of default, bank officer lending decisions have in principle been subject to review by the anti-corruption Central Bureau of Investigation and its Central Vigilance Commission. This has reinforced caution on the part of front-line lenders. Discussions with RBI culminating in autumn 2003 have led to a change in the vigilance regime in which commercial decisions taken in good faith are supposed to be exempt, but this will take time to be widely absorbed.

In terms of macro factors for success and failure, our judgements about the enabling environment in India result in the scores shown in Table 1.
## Table 1 Assessment of Enabling Environment against Factors for Success

<table>
<thead>
<tr>
<th>Factors for Success</th>
<th>Factors for Failure</th>
<th>Assessment</th>
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<td></td>
<td></td>
<td>1  2  3  4</td>
</tr>
<tr>
<td><strong>Macro Factors</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1  an open, competitive banking environment wherein there are a number of independent banks, a majority of which are interested in expanding their client base, establishing niche markets, or protecting market position;</td>
<td>• a thin banking sector that is controlled by a few powerful vested interests, in which banks are sufficiently profitable with their existing, limited clientele to support the financial and/or political ambitions of those controlling interests;</td>
<td>√</td>
</tr>
<tr>
<td>2  a monetary and regulatory environment that is conducive to lending to SMEs, in particular with sufficient liquidity and stable interest rates that allow for appropriate risk/return pricing;</td>
<td>• restricted liquidity for SME lending and/or excessive interest rate risk that discourages opening up new markets;</td>
<td>√</td>
</tr>
<tr>
<td>3  a dynamic and/or expanding business sector within which viable opportunities are available for exploitation by new entrants including MSMEs;</td>
<td>• a thin business sector that is not under pressure to change or reform, in particular to become more inclusive;</td>
<td>√</td>
</tr>
<tr>
<td>4  a framework for business (political, policy, legal, regulatory and social) that, in its application as well as its theory, is supportive of enterprise in all its forms including MSMEs.</td>
<td>• endemic corruption and/or incompetence that distorts and/or restricts the operation of market forces and discourages MSMEs from entering the formal economy.</td>
<td>√</td>
</tr>
</tbody>
</table>

### Credit Guarantee Fund Trust for Small Industries (CGTSI)

CGTSI, Credit Guarantee Fund Trust for Small Industries, was formally launched in August 2000, by its settlors the Government of India and the Small Industries Development Bank of India (SIDBI), who supplied capital in the ratio 4:1. In September 2003, the coverage was extended, from SSI enterprises in manufacturing and IT/software only, to encompass small firms in industry-related business services.

CGTSI is a classical guarantee fund, which shares the risk of default on eligible loans in return for guarantee premiums. These are an initial 2.5 percent of the loan and an annual service fee of 1 percent of the outstanding amount. The commercial relationship is between the Trust and the lending bank. All the appraisal work and post-claim recovery work is delegated to the banks, which choose which loans they want to have covered. This is in contrast to the previous DICGC scheme in operation until 1997, when banks withdrew from it following late and disputed payments, in which all loans in priority sectors were automatically covered, and all attracted premium payments.

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9. Where 1 = “very much so”; 2 = “to some extent”; 3 = “only slightly”; 4 = “not at all”.

10. Those with investment of less than Rs 1 million (approx. USD 22,000) in plant and machinery
While the headline risk share of the new scheme is 75 percent, there are two features which reduce the liquidity of the guarantee to the banks. First is a two year lock-in period before any claim can be made irrespective of the term of the loan, and second is that the initial pay-out, done within 30 days of the claim, is only 75 percent of the guarantee cover. Any further payment due is made only after all amounts recovered have been passed to CGTSI at the end of the legal recovery process, which may be subject to long delays. The effective immediate liquidity is thus 56.25 percent of the principal outstanding plus, on working capital loans, accrued interest\(^{11}\).

**Institutional Framework**

The institutional arrangements appear to be flexible and unbureaucratic. There is a board of four trustees, consisting of the Chairman of SIDBI and the Secretary at the Ministry of SSI, representing the two settlors, together with the Chairman of the Indian Bankers Association (IBA) and the CEO of the CGTSI. The board meets about every two months, and has considerable freedom, under the trust deed, to change policies and operational conditions. In addition there is an IBA review forum, consisting of 5 bankers and an IBA representative that meets twice yearly, and a larger National Advisory Committee, consisting of the board and 12 additional professionals, including bankers, SME associations, a representative of the central bank and others, which meets annually. The Trust is not itself a financial institution and does not come under the direct supervision of the central bank the Reserve Bank of India (RBI). There is currently no official formula or ceiling on maximum leverage, but in discussions, the possibility of moving to a 5:1 position by 2010 was included.

**Financial Structure**

As the scheme builds up the volume of its activities in the next few years it is envisaged that further capital tranches beyond the current Rs 7 billion will be provided by the two settlors, up to the commitment so far announced of Rs 25 billion, or about USD 550 million. Given the two year lock-out condition for claims, and the recent launch of the scheme, the actual balance between claims costs, administration, and guarantee fee income is not yet known. Currently investment income on the fund is very large in relation to fee income, which has allowed a rapid build-up of provisions amounting to 27 percent of guarantees outstanding at March 2004. Given the anticipated default rates level, cited in discussion as likely to be in the region of 20 percent, it would seem that, strategically, there is an acceptance that at least part of the investment income might be needed in future to supplement fee income to cover full claims costs.

**Dissemination**

CGTSI aims to enrol all eligible banks as Member Lending Institutions (MLIs), through a simple contract that does not stipulate any minimum level of activity. Eligible are public, private and foreign commercial banks, those regional rural banks classified by their sponsoring body as having sustainable viability and some other government owned development banks such as SIDBI, NSIC and NEDFI. Public sector banks were the first to sign up, many, if not all, doing so from traditional compliance rather than commercial or profit considerations. The interaction between CGTSI and MLIs is mainly through internet linkages, using a sophisticated, specially-

\(^{11}\) up to 90 days
written software suite, which is being developed to handle claims as well as all other aspects. A system of random sample inspections is planned to ensure that MLIs are following their normal internal loan origination and monitoring standards when using the guarantee.

The managers responsible for CGTSI in public sector banks are usually those in charge of Priority Sector lending which includes the SSI sector. In the private sector bank, two separate business groups were involved and discussions had also involved the risk management office.

A large amount of CGTSI effort has been put into training of banking officers, through holding workshops where officers from 2 or 3 banks participate, and by identifying internal bank training leaders to channel material. This effort is still increasing. Some 40 workshops have been held in the three months to August. There are some 65,000 bank branches in India. Many in rural areas are not yet computerised and therefore cannot take advantage of the on-line B2B model used by CGTSI. Another major effort, and expenditure, has been multi-channel marketing and awareness campaigns, which reach out to SSI associations as well as to bankers.

Up to now, there has been no price or risk-coverage differentiation in terms of the type of loan the guarantee covers, the sector or the performance of the particular MLI. These are all possibilities for the future. Access to the guarantee service might be restricted if claims levels were particularly high, although this has not been formalised.

The volume of business has been modest, at approximately 18,000 proposals approved from scheme inception to August 2004, although growth has accelerated strongly during 2004. Current management has a high target for the 2010 horizon: to multiply the volume to around 600,000 to 700,000 operations outstanding thus achieving a penetration of about 25 percent of the registered SSI population, which would translate into a coverage of about 6 percent of total SSI lending, and as much as 40 percent of loans under Rs 2.5 million.

Findings

Assessment of the CGS

Design Philosophy and Strategic Approach

CGTSI regards the SSI borrowers as its prime customers, with the banks as intermediaries, although awareness and marketing are addressed to both constituencies.

Several of the public sector banks interviewed referred to a Government request to join the scheme and/or compliance with government SME policy being a factor in their decision to join. The fact that the guaranteed loan business was or could be profitable was acknowledged, but appeared to be a secondary consideration.

Following a slow take-up after the launch, the new management team, led by a senior banker with experience in development banking, has paid especial attention to establishing bilateral relations with banks at top level, and is stressing the commercial advantages of using the instrument. The focus is on the opportunity to expand profitable SSI lending to borrowers without collateral.
The fact that there is an interest rate ceiling on guaranteed loans of 3 percent over the prime lending rate of participating banks has not so far been a deterrent, given the spreads currently available.

The stated rationale of CGTSI is that, despite its priority sector lending status, the SSI sector has not received sufficient attention from the banking system. According to CGTSI, this is mainly because of an exaggerated perception of the sector’s risk, which has led lenders to focus on collateral based lending. The underlying aim of CGTSI is “to bring about a paradigm shift from collateral based lending to project based lending in this sector.”\(^{12}\) This change of attitude, were it indeed required, could be classified as financial deepening, and could include indirect effects beyond guaranteed transactions.

Head office bankers interviewed tended not to accept that lending to SSI was generally collateral led, claiming that projects were assessed at the branch for internal technical and economic risk before questions of available security for a loan were addressed. But with thousands of branches, and a traditional cautious climate, it would be surprising if this practice was absent. For example, one bank admitted that some “officers required to be transformed from the old mind-set of security based lending to merit based lending”.

In line with the rationale, a key feature of the CGTSI scheme is that loans subject to guarantee must not have any collateral or third party guarantee. This applies even if the total loan amount is greater than the Rs. 2.5 million allowed to be the subject of the guarantee cover. The guarantee may not be used to top up any available collateral. The bank is thus at full risk on the unguaranteed portion, apart from any primary security (the value of the asset financed by the loan) and any personal guarantee from the borrower. This approach is distinct from many CGS which aim to ease the problem of collateral shortage, but not to encourage (or perhaps even allow) the replacement of collateral where it is available and acceptable to both banker and borrower. Under CGTSI, there is no requirement to exclude refinancing of existing loans, and indeed some loans are having their collateral released and being refinanced using the scheme.

One interesting reaction to CGTSI is an instruction issued by a particular bank that regular internal follow-up of loans sanctioned will include a requirement for an explanation for any case where a guarantee could have been used and was not, that is despite the availability of collateral. This reflects a view from the top that the guarantee, even with its modest 56.25 percent liquid pay-out, is preferable to collateral, given the delays in the legal system and the low eventual recovery from asset sales.

On the other hand, other bankers may feel the coverage of the CGTSI is insufficient, and may be thereby discouraged from sanctioning larger loans where partial collateral is available but would be ruled out under current rules. CGTSI management is aware of this issue, and under consideration is a possible relaxation of the strict no collateral rule, although this will have to be handled very carefully as it risks confusing the market place.

Another bank in its interview response referred to the “hue and cry made by representatives of associations of Small Scale Industries regarding return of all

\(^{12}\) Annual Report 2001-2, CGTSI.
collateral securities now held by the banks for the finance extended by them in lieu of guarantee coverage”, and also suggested “making the scheme optional from the side of the entrepreneurs”. These comments reveal that there is at least a degree of misunderstanding about the intentions of the scheme.

Complicating the issue of clarity of CGTSI’s design and strategic approach has been the influence of RBI’s broader signals about SSI lending. This has affected CGTSI’s perception in the market place. In April 2000, six months prior to CGTSI’s launch, RBI issued a circular\textsuperscript{13} effectively instructing lenders not to take collateral on SSI loans of under Rs 0.5 million to the smallest\textsuperscript{14} SSI firms. In January 2002, this guidance was extended to loans in this size range to all SSI firms. Other circulars issued in 2002 and 2003 gave permission for banks to waive collateral requirements on larger loans to the sector, up to Rs 2.5 million (CGTSI’s maximum) if certain track-record and financial parameters were met by the borrower.\textsuperscript{15}

When CGTSI withdrew cover for loans up to Rs 0.5 million in February 2003, on the grounds that banks were in any case instructed not to take collateral, there was strong opposition, and CGTSI had to reverse this change after six months. We suspect that many banks have been, initially at least, using the guarantee scheme to cut their exposure in the under Rs 0.5 million loan segment, and there may be many cases of refinancing. This is strongly supported by data on loan size, which show that over 93 percent of the number and nearly 40 percent of the amount of guaranteed loans fall into this band. Public sector banks had a tradition of making collateral-free loans in this size range under various social lending schemes, even before the RBI guideline of April 2000.

Borrowers have naturally objected to paying high fees for a guarantee, especially where a collateral-free loan at no extra interest rate was previously on offer. One result is that eight of the thirty active member banks are now absorbing some of the fee costs by sharing them with borrowers. Another response noted is a guideline that if primary security, that is the value of assets for which the funds are required, is 150 percent or more of the loan, then the manager has discretion whether or not to use the guarantee – that is, leave the loan simply collateral-free.

In its basic structure, CGTSI does represent a significant advance on the old DICGC automatic portfolio scheme, under which bankers had no discretion at all, and were being used as a channel to pump credit through to vast numbers of SMEs in priority lending sectors, on which as a whole banks sometimes lost money. CGTSI’s software based B2B model, with its 30 day payout rule\textsuperscript{16}, and clear conditions, also contrasts favourably with the administratively complex and slow claims procedure of the old scheme, which eventually collapsed under a huge backlog of claims.

On balance, though, we have some doubt as to whether the CGTSI approach is yet clear enough in its aims, and sufficiently sympathetic to market forces and to the commercial realities of lending to the sector, to enthuse the banks to the degree required to meet its ambitious growth targets. There certainly seems a need for RBI

\textsuperscript{13} The circular, interpreted universally as an instruction, was in the form of a “dispensation from collateral requirement” which implies from provisioning rules, although we have been unable to confirm this at time of writing.

\textsuperscript{14} “Tiny” sector, with plant and equipment investment under Rs 2.5 million (USD 55,000)

\textsuperscript{15} Banks have not responded by charging higher interest rates for collateral-free loans

\textsuperscript{16} Though it has yet to be tested in practice beyond a very small number of claims.
to have an approach to the SSI sector more co-ordinated with that of CGTSI, or possibly vice versa.

CGTSI has clearly been set up with a long term perspective, and the fact that a future resource commitment of some Rs 25 billion (USD 550 million) from the two trustees was announced early on will have reassured the market. Some senior SME bankers are still cautious, having a poor recent experience from the previous DICGC scheme, and are waiting to see how claims are handled after the two year lock-out expires. Only 10 claims had been paid out at the time of our field visit. The overall claims costs for the new scheme are as yet an unknown quantity, and there is no actuarial model as yet to indicate the long term solvency although, as mentioned previously, provisioning has been conservative.

Beyond the stated aim to achieve a shift away from collateral-based lending, which has had a mixed reception so far, CGTSI has longer term plans to feed back to the banks the detailed risk information it generates on the SSI sector. If this information is good quality it may indeed result in reassessment of risks within the SSI sector and contribute to a more market led and competitive approach on the part of public sector banks.

Encouraging a competitive approach among member banks has not been given a distinct priority by CGTSI so far, although some member banks have begun asking for their up to date rankings within the activity statistics. That differential charging according to bank performance was a possible future policy was acknowledged in discussion, but it is currently remote.

CGTSI has elements of a participative approach. Apart from the review committee of representatives of five member banks which meets twice a year, and can make recommendations for example on streamlining claims procedures, there is a separate Disputes Review Mechanism being set up under IBA auspices for member banks independent of CGTSI.

Up to now, there has been no official suggestion that these elements could eventually develop into “ownership” in the sense of direct participation by member banks in governance (currently only through the Chairman of the IBA). Also remote, although understood by CGTSI management as a possible long term development, is the idea that banks other than SIDBI could contribute to the corpus of the guarantee fund.

**Negative Evidence**

One bank expressed the fear that there might be a new tendency to default on the part of guaranteed borrowers. This may also reflect the fact that under current rules neither collateral nor any third party guarantee is allowed, and that wilful defaulters may see an opportunity. Of course the same argument can be advanced for the smallest size loans, up to Rs 0.5 million, that have been issued collateral-free without the CGTSI guarantee.

The private sector bank, while interested in the contribution that CGTSI could make to its plans for certain segments amounting to Rs 7.5 billion of new lending, recognised that the current loan limits at Rs. 2.5 million were low in relation to its upper exposure limit for the target group of Rs. 30 million.
### Summary

The assessment of CGTSI against our micro factors for success and failure is set out in Table 2.

### Table 2 Assessment of CGTSI against Factors for Success

<table>
<thead>
<tr>
<th>Factors for Success</th>
<th>Factors for Failure</th>
<th>Assessment&lt;sup&gt;17&lt;/sup&gt;</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Micro Factors</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1 an influential “champion” (or champions) within the lender(s) who actively promotes the CGS for appropriate commercial reasons;</td>
<td>lack of support or lack of understanding of the commercial logic of the CGS within the lender(s);</td>
<td>√</td>
</tr>
<tr>
<td>2 a “financial sector” approach to CGS design that focuses on the goal of achieving a permanent deepening of the financial sector;</td>
<td>a “social sector” approach that focuses exclusively on a short-term goal of pushing finance to the SME sector and the use of financial institutions as conduits for that purpose;</td>
<td>√</td>
</tr>
<tr>
<td>3 an understanding of and empathy with market forces, particularly for providers of financial intermediation services;</td>
<td>an emphasis on the social obligation of lenders or compliance with laws, regulations or policies</td>
<td>√</td>
</tr>
<tr>
<td>4 a long-term approach that emphasises institutional and financial sustainability, with objectives directly related to financial sector deepening, even if project interventions are short or medium term in duration;</td>
<td>a project approach that focuses on short-term objectives that are limited to the period of the project intervention, rather than directly related to long-term financial sector deepening;</td>
<td>√</td>
</tr>
<tr>
<td>5 extensive transfer of appropriate lending “technology” in terms of policies, procedures, methodologies and systems through carefully focused technical assistance;</td>
<td>reliance on targets for achievement of project lending objectives without regard for the ongoing sustainability of institutional processes;</td>
<td>√</td>
</tr>
<tr>
<td>6 a participative approach that achieves a balanced partnership between donors, CGS and lenders for achievement of agreed objectives;</td>
<td>a paternalistic approach that imposes a CGS project on reluctant lenders who do not understand or do not agree with the stated objectives;</td>
<td>√</td>
</tr>
<tr>
<td>7 ownership by lenders of the CGS stemming from clear and significant benefits to lenders in terms of assistance to open up new markets for profitable commercial exploitation.</td>
<td>coercion of lenders through a “carrot” (non-transparent benefits unrelated to financial sector deepening) and/or “stick” (pressure from political or regulatory authorities) approach.</td>
<td>√</td>
</tr>
</tbody>
</table>

<sup>17</sup> Where 1 = “very much so”; 2 = “to some extent”; 3 = “only slightly”; 4 = “not at all”.

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Do Credit Guarantees Lead to Improved Access to Financial Services? / Case Study - Egypt / February 2005
Overall Financial Deepening Performance and Impact

Our judgement is that, so far, little or no direct deepening has occurred. The impact of the CGTSI scheme has been too small for any measurable effects. Indirect deepening whereby the experience of using guarantees affects lending to SMEs in general is naturally a more distant possibility.

The bulk of transactions to date, because they overlap with the RBI’s instruction to lend collateral free, have not been additional or pushed outward the boundaries of SME lending practice.

There has been a slow take-up of the new scheme from its launch at the end of August 2000, resulting in a total of 3,200 operations by March 2002, 8,200 by March 2003, and 14,800 by March 2004. This is partly due to the need to overcome banks’ resistance after the previous scheme lost their confidence. It has probably also been affected by two changes of CEO at CGTSI, one due to a sudden death. However, it mainly suggests that the appetite for the guarantee product, at least as it has been presented to date, has been limited. Thus the lack of deepening so far is not, in our view, solely, or even largely, due to the newness of the scheme.

The key question is whether the combination of the enabling environment and the basic design and strategic approach of the scheme is likely to achieve substantial deepening in the future, or whether these will remain insufficiently favourable. The take-up of the scheme is now accelerating, following a shift of emphasis towards more pro-active marketing and a greater stress on the commercial benefits, but the offering has not so far changed. The environment is improving slowly, and the CGTSI governance allows for flexible responses to bank feedback in the form of changes to the rules. The next year will be a crucial one, as the scheme has been through its launch phase, and may be in danger of having its market perception solidified based on bankers’ first reactions.

Key factors explaining this result include the following.

Enabling Environment

- On the whole the banking climate has been insufficiently competitive to make guaranteed loans in the SSI sector a commercial priority.
  - Opportunities to make profits in other sectors including the rest of the SSI sector, within a rapidly growing economy, have been available
  - Competition within public sector banking and from private banks is not yet a significant force in the SSI sector
  - The RBI’s administrative and directed lending approach still strongly influences attitudes to the SSI sector on the part of public sector banks
  - The opportunity to reduce exposure to RBI mandated collateral-free loans has dominated thinking about the use of CGTSI

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18 The amount of credit guaranteed in the April – June quarter 2004 was 3.6 times that of the same quarter in 2003, with average transaction size rising much faster than the number of transactions
Appendix A7 – Case Study - India

**CGS Institutional**

- Co-ordination between RBI and CGTSI in their messages to both lenders and borrowers in the SSI market has been insufficient
- The approach of CGTSI and its mission has been primarily to push for a change in a banking habit rather than to respond to a commercial need

**CGS Operational**

- The rules do not allow for the commercial need to use guarantees to top-up partial collateral
- The modest liquid risk coverage at 56.25 percent, coupled with the low loan ceiling, makes CGTSI a minor opportunity for SSI banking managers.

**Suggestions for Improvement**

We think that it will be necessary for bankers to change their commercial perspective on the smaller end of the SSI sector, and that this is not something the CGTSI can achieve by itself. What is required is for the messages from RBI about the segment to be more unequivocally commercial. If the largest public bank, the State Bank of India succeeds in its aim to more than double its exposure to the SSI sector in the current financial year, that will also be a powerful message to the sector. Competitive behaviour and differential approaches by banks need to be to be encouraged in every way. RBI could remove administrative guidelines on SME lending, especially those concerning collateral. The stance on multibanking (and, by extension, on switching banks) by SSI firms, at present one of discouragement, should be at least moved to neutral. Once commercial credit information improves sufficiently, the stance could move to a positive one. Under these more competitive conditions, CGTSI’s role in providing guarantee products, tailored to this market and specifically to collateral shortages, will then be increased.

CGTSI management, while pushing hard to expand transaction volume, is keen to raise average loan sizes as well.

We support relaxing the strict no-collateral rule in certain cases, so that the guarantee would be used in addition to available collateral. This would encourage larger loans and allow a wider commercial use of the guarantee.

We also support management’s consideration, stemming from market demand, to increase the maximum loan limit covered by the guarantee to Rs. 5 million (USD 110,000). Taking the loan limit beyond the point at which RBI’s guidelines on collateral-free loans are in force seems a good strategy.

Finally, we would support the early introduction of differential guarantee pricing, based on bank activity and performance under the scheme, as a further instrument to encourage a competitive and differential approach by banks to using the scheme and marketing it to borrowers.
Executive Summary

The Study

This case study of the credit guarantee operations of the Lublin Development Foundation (LDF), Poland, forms part of the 2004 research effort mounted by DFID into the role of credit guarantee schemes in promoting financial deepening. The study aims to shed light on the factors and circumstances determining the degree, if any, of financial deepening that results from the operations of credit guarantee schemes (CGS), working with banks that are lending to Small and Medium Enterprises (SMEs). Financial deepening refers primarily to increasing access to financial services by those previously unable to access such services, but also to the appropriateness of those services to the needs of the new target groups.

In other cases, we found it useful terminology to distinguish between direct deepening, which refers to effects linked directly to the current use of guarantee products by banks, from indirect deepening, which refers to broader effects on bank behaviour brought about by their experience of guarantee usage. However, in this case, we found it difficult to distinguish the (largely historical) direct effects from indirect and unrelated deepening that has taken place, and continues to take place, in the Polish economy.

The LDF in Poland was chosen as one of the four case studies because of the historical interest of DFID, which assisted in the establishment of the credit guarantee activities of LDF through the Polish-British Enterprises Project (PBEP), 1995-99. There was also an interest in investigating one regional, as opposed to national, CGS within the overall study. A particular interest was to investigate the transition from donor-funded project to institutionally and financially self-sustaining organisation, and in particular to see if this change initiated or accelerated drift away from the initial project objectives and mechanisms.

The research method consisted of personal interviews with the management team of LDF and with a selection of its participating banks, using structured questionnaires as the basis of discussions. The selection of participating banks was designed to provide examples of heavy and light users of the credit guarantee services of LDF.

The researcher was greatly assisted during the field visit by the officers and staff of LDF and had opportunities for extensive discussions with members of the management team beyond the formal interviews. Interviews were conducted with three banks in Lublin and one in Warsaw.

Key Findings

The main evidence for financial sector deepening of the direct kind was:

Carried out in Poland between 12 and 16 September, 2004.
Appendix A8 – Case Study - Poland – Executive Summary

- strong competition in the SME sector by a broad cross-section of major and secondary private and publicly owned banks;

- clear focus on provision of financial services to SME by most banks, including dedicated departments and credit officers, specialised products, simplified procedures and targeted marketing;

- strong and increasing competition on both quality and cost of services; and

- reportedly large and increasing direct lending by banks to SMEs without support of guarantees or subsidised funds.

Separating the causality of these positive developments was difficult. It appears that the role of LFP was important when it started operations, when banks were afraid to lend to any SME without a guarantee. Now LFP is more marginal to banks dealing with SMEs as credit guarantees are used only in those instances where viable clients lack sufficient security.

Poland banks remain highly conservative and the researcher felt there was still a role for LFP. However, a comprehensive review of products, models and delivery methodologies is required to make LFP more relevant in a rapidly changing financial sector.
Case Study - Poland

Introduction to Poland

Poland is an upper middle income country, with a population of 38.6 million growing at 0.02 percent per annum and a labour force of 17 million. Unemployment was a very high 20 percent in 2003.

GDP was USD209.6 billion in 2003\(^2\), an increase of 3.7 percent from 2002. GDP was USD427.1 billion (purchasing power parity) in 2003. The informal economy represents approximately 27.6 percent of total Gross National Income.\(^3\) GNI per capita (Atlas method) was USD5,270 equivalent in 2003. Approximately 18.4 percent of the population lives below the national poverty line.

Exports of goods and services of USD57.6 billion in 2003 made up 21.0 percent of GDP in 2003, a decrease over the 27.7 percent recorded in 2002. At the time of the country visit, average deposit rates on 3 month deposits were approximately 2.8 percent and the refinance rate was 7.00 percent. The inflation rate was 0.7 percent in 2003. The exchange rate for the Zloty at the time of the country visit was PLN 3.6434 per US dollar and PLN 4.4355 per Euro.

Standard and Poors’ assigned a credit rating of BBB+ to Polish long-term, foreign currency sovereign debt. Moody's assigned a A2 (stable) rating to Polish sovereign debt.

On Transparency International’s corruption perception index, Poland is ranked 64 out of 133 countries, tied with Mexico.

Assessment of the Enabling Environment

Poland pursued a policy of economic liberalisation throughout the 1990s, with the government's determination to enter the EU shaping most aspects of its economic policy. Poland's economic liberalisation is counted as a success story among transition economies. Poland's banking system is the most developed in Central and Eastern Europe, and continues to modernise. The central bank, the National Bank of Poland (NBP), is the regulatory body responsible for the issue of money and control of the monetary and credit policy in Poland. It grants banking licenses and foreign exchange permits.

The reform of the Polish banking system started in the late 1980s.\(^4\) During the initial stage of the restructuring process, the focus was on establishing new laws to create...

\(^2\) World Development Indicators database, August 2004.
\(^4\) The Polish Banking System in the 1990s, National Bank of Poland, updated 2001; also Poland’s Banking Sector, Bruno Lill, Centre for Markets in Transition, HSE, October 2001, updated by Ville Rämänen in October 2002 and Iana Pietarinen in May 2003.
a private banking sector and break up the state-owned banking monopoly. The majority of Polish banks have been privatised and the majority of banking sector assets, deposits and equity are now in the hands of the private sector. Banks set their own interest rates based on several factors, particularly the inflation rate, reserve requirements, and the National Bank of Poland (NBP) rates.

One of the main factors in the Polish banking industry is the dominance of PKO BP.\(^5\) PKO is the unquestioned market leader, posting nearly half of the total banking sector profits in 2003. It is doubtful that any other bank will threaten PKO's dominant position in the coming years.

Gross domestic savings rate 13.9 percent of GDP, somewhat less than the average for upper middle income countries. Banks are not constrained by liquidity.

SMEs are a leading sector of the Polish economy.\(^6\) They represent 99.8 percent of all enterprises in the country and total over 1.65 million active SMEs, of which 99.0 percent are small businesses. The SME sector's share of GDP is 48.4 percent, with small enterprises generating 39.4 percent and medium-sized ones 9 percent. SMEs are an important source of employment, employing over 67 percent of the total active workforce. SMEs in Poland are increasingly active in foreign trade: the share of the SME sector in total exports amounts to 43.9 percent (USD15.85 billion equivalent). Out of total SME exports, almost 50 percent is contributed by medium-sized enterprises, around 26 percent by small enterprises (employing from 10 to 49 people) and around 24 percent by micro enterprises (employing up to 9 people).

The Government of Poland is committed to supporting the development of the SME sector. This is because SMEs form the backbone of the market economy and is significant with respect to employment. In addition, however, support to small enterprises helps in de-monopolisation of the economy and preservation of social stability through the development of a large middle class.

In 1995 the Polish Government introduced a special Program for SME Development. The government's actions aimed at improving the enabling environment for SMEs, and are set out in the legislative package called "Business First". This included legal reforms to simplify the tax system, reduce labour costs, make work relations more flexible and eliminate bureaucratic barriers. Actions supporting SMEs are also included in the National Preparation Programme for EU Membership, including:

- establishment in 1995 of the **Polish Foundation for Small and Medium Enterprise Promotion and Development** with PHARE assistance;
- established in 1997 of the **National Credit Guarantee Fund** to guarantee bank credits for Polish companies and municipalities;
- founding in 1997 of the **Techniques and Technology Agency**, the main objective of which is promotion and support of modern and innovative techniques and technologies to increase the competitiveness of Polish products; and

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\(^5\) IMF, EBRD's Investment Profile 2001.

creating local guarantee funds under the PHARE Local Initiatives Program, to support development of SMEs in rural areas.

The National System of Services for SMEs (KSU) was created as a network of 136 independent centres realising co-ordinated activities for SMEs. These centres provide four types of services to SMEs:

- **consulting services** - basic consulting for starting up SMEs and specific consultation in marketing, finance, law, planning and management, human resources implementing innovations, export promotion, quality improvement and environment protection;

- **training services** - for starting up including specific (marketing, finances, management etc.) and general (language, computer) training;

- **information services** - linking of the trade partners, verification of the company credibility, information on trade fairs etc.; and

- **financial services** - assistance in gaining financial support.

The government’s intention is that national and local governments will take a role to strengthen the system of guarantee funds and loan funds that aim to increase the financial capacities and credit-worthiness of enterprises. It is the government's intentions to accomplish this through funds that will not violate competitiveness principles, but fit into a market niche which has not been filled by the banking system.7

Poland has no public credit bureau. However, two private credit reporting agencies, Creditreform and D&B Poland, one of the Dun & Bradstreet group of companies, operate in the country.

Poland is better than average for its region in its enabling environment for business. 8 It takes 10 procedures (regional average 9, OECD average 6) and 31 days (regional average 42, OECD average 25) to start a business in 2004. Cost of starting a business as a proportion of gross national income per capita is 20.6 percent (regional average 15.5 percent, OECD average 8.0 percent). It takes 41 procedures (regional average 29, OECD average 19) and 1,000 days (regional average 412, OECD average 229) to enforce a contract, from the time a plaintiff files a law suit to the time of actual payment. The cost is 8.7 percent (regional average 17.7 percent, OECD average 10.8 percent) of the debt. It takes 1.4 years (regional average 3.3, OECD average 1.7) and 18 percent of the estate (regional average 13.1 percent, OECD average 6.8 percent) to resolve bankruptcies, resulting in a recovery of 68.2 percent (regional average 30.5 percent, OECD average 72.1 percent).

Measures on credit information sharing and the legal rights of borrowers and lenders show a somewhat similar, if less positive, pattern. One set of indicators, measuring how well collateral and bankruptcy laws facilitate lending, ranges from 0 to 10, with higher scores indicating laws better designed to expand access to credit. Poland has a score of 2 (regional average 5.4, OECD average 6.3). A Credit Information Index measuring the scope, access and quality of credit information available through

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7 Mr. Mirosaw Marek, CEO of the Polish Agency For Enterprise Development.
8 Doing Business – Snapshot of Business Environment, World Bank / IFC
Appendix A8 – Case Study - Poland

public registries or private bureaus ranges from 0-6, with higher values indicating that more credit information is available from a public registry or private bureau. Poland has a score of 5.0 (regional average 2.0, OECD average 5.0).

In terms of the study thesis and macro factors for success and failure, Poland scores above average on the factors identified, as shown in Table 1.

Table 1 Assessment of Enabling Environment against Factors for Success

<table>
<thead>
<tr>
<th>Factors for Success</th>
<th>Factors for Failure</th>
<th>Assessment</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Macro Factors</strong></td>
<td></td>
<td>1 2 3 4</td>
</tr>
<tr>
<td>1 an open, competitive banking environment wherein there are a number of independent banks, a majority of which are interested in expanding their client base, establishing niche markets, or protecting market position;</td>
<td>• a thin banking sector that is controlled by a few powerful vested interests, in which banks are sufficiently profitable with their existing, limited clientele to support the financial and/or political ambitions of those controlling interests;</td>
<td>✓</td>
</tr>
<tr>
<td>2 a monetary and regulatory environment that is conducive to lending to SMEs, in particular with sufficient liquidity and stable interest rates that allow for appropriate risk/return pricing;</td>
<td>• restricted liquidity for SME lending and/or excessive interest rate risk that discourages opening up new markets;</td>
<td>✓</td>
</tr>
<tr>
<td>3 a dynamic and/or expanding business sector within which viable opportunities are available for exploitation by new entrants including MSMEs;</td>
<td>• a thin business sector that is not under pressure to change or reform, in particular to become more inclusive;</td>
<td>✓</td>
</tr>
<tr>
<td>4 a framework for business (political, policy, legal, regulatory and social) that, in its application as well as its theory, is supportive of enterprise in all its forms including MSMEs.</td>
<td>• endemic corruption and/or incompetence that distorts and/or restricts the operation of market forces and discourages MSMEs from entering the formal economy.</td>
<td>✓</td>
</tr>
</tbody>
</table>

Lubelski Fundusz Przedsiębiorczości

Lublin Development Foundation (LDF) was established as a foundation in 1991 as the first of its type of regional development agencies. It was established by a group of regional organisations including banks, economic foundations, chambers of commerce and business associations, the Lublin Municipality and the State Treasury, to cover the entire region, composed of several voivodships, in the southeastern part of Poland. Its Founders’ Board consists of LDF’s main clients and beneficiaries, including local authorities, banks, entrepreneur associations and the state administration. A Management Board is responsible for day to day operation of the foundation. Branches operate as independent financial and organisational units (profit centres).

Where 1 = “very much so”; 2 = “to some extent”; 3 = “only slightly”; 4 = “not at all”.

A8.6
LDF considers both local authorities and entrepreneurs as its beneficiaries. It offers services to its beneficiaries at a price that varies according to the market sub-group - established businesses are charged more than start-ups or companies in financial difficulties – but in general LDF’s prices are set below market rates: LDF is not a profit-oriented organisation. At the same time, financial self-sustainability is a goal of the LDF and its subsidiaries. This dichotomy is achieved by defining self-sustainability as including income from project funds, which covers those services that LDF delivers at below cost prices. LDF is not “subsidised” by either local authorities or the government, although local authorities may choose to “invest” in LDF activities to achieve a social return.

LDF serves as a holding entity for several separate legal entities, although operations are carefully coordinated and in general discussions LDF together with its subsidiaries is still referred to as the Foundation. The companies held by the foundation include credit guarantee, equity investment, ISO9000 certification, consulting and training companies. LDF is also one of the founders of a business incubator. The LDF thus is at the head of a complex system of complementary activities for regional development.

In 1995, LDF was offered a contract to manage the Lubelskie Voivodship part of the Polish-British Enterprises Project (PBEP), a project to support enterprise development. A total of USD9.5 million was provided for market and business development and establishment of a credit guarantee fund and an equity investment (venture capital) fund. This project provided a large boost to LDF’s operations.

Lubelski Fundusz Przedsiębiorczości sp. z o.o.(LFP) was therefore established in 1995 as a limited liability company wholly owned by LDF, funded with USD2 million equivalent in capital funds from PBEP. These capital funds were left with LFP, without restriction, when PBEP finished in 1999. In the meanwhile, LFP has received Euros 2 million as additional capital from the Ministry of Economy and Labour for implementation of Phase 2000 ESC – Regional Loan Guarantee Fund.

In addition to guaranteeing loans for SMEs, LFP also cooperated with local authorities to set up loan guarantee funds to secure loans advanced by labour offices to unemployed individuals to set up their own businesses. This practice has stopped since EU accession because it violates EU law.

LFP sees the banks as their strategic client, but the SMEs that are recipients of their services are also important. The goals of LFP include: improving access to bank loans for entrepreneurs with insufficient security; participating in the establishment of financial support organisations focused on SMEs; assisting in new job creation; and reducing the risk of lending to SME to lenders, by so doing stimulating their interest in supporting the SME sector. LFP recognises that these goals can not be achieved without the support of its participating banks.

LFP’s sole business is provision of credit guarantees. This is seen as an advantage as it offers full transparency with respect to the efficiency of its guarantee function, and partner banks do not have to be concerned that other business ventures may place the capital of the company under threat.

LFP remains a regional fund focused exclusively within Lubelskie Voivodship, although this itself has been expanded from the geographical area covered when the project first started. Having as one of its aims the promotion of the SME sector, LFP
has thought extensively about how it can influence banks to provide better service to the sector. Changes in the structure of the Polish banking sector impacts on their ability to do this. At the time LFP was formed, three of its original participating banks were headquartered in Lublin. Since then, mergers and acquisitions have caused all three headquarters to move to Warsaw, where a regional fund like LFP necessarily is seen as less important to the bank’s new national objectives, and a weaker partner. National credit guarantee funds such as that of Bank Gospodarstwa Krajowego therefore have received increased attention from the banking sector simply because of its national coverage.

On the other hand, some banks interviewed expressed the opinion that regional CGS would continue to be natural partners of the banks, including national banks, because of their detailed knowledge of local economic, political and social conditions, particularly as they pertain to SMEs. This local knowledge, which is not available to banks, makes regional CGS particularly qualified to make risk-based decisions about SMEs, and take on the risk associated with such decision, which banks cannot.

Government policy has changed in recent years and its stated intention is to fund credit guarantee funds around the country. One proposal is that 16 regional funds will supervise smaller funds in their region to strengthen and standardise the credit guarantee industry. Some CGS have been operating for up to 12 years but they are not sufficiently well capitalised. LFP sees this change in government policy as an opportunity and is working hard to be designated a Regional CGS. Currently LDF is implementing the EU Phare 2000 programme and is tendering for funds from the Polish Agency for Enterprise Development (PARP), which will increase its capital by a factor of four. Some banks are now cooperating with local authorities and NGOs to form single-bank specific CGS. Some of these are very well capitalised. LFP is dubious about such arrangements and their potential to lead to increased growth of the SME sector: this researcher shares their concern.

**Lublin Voivodship**

As LDF is a regional development agency operating a regional credit guarantee fund, the characteristics of the region are perhaps more relevant in some aspects than the characteristics of Poland as a whole. Lublin Voivodship is a predominantly agricultural region (agriculture accounts for about 50 percent of employment). In 2000 there were only 111 employers registered in the region, of which some 95 percent were SMEs. Many more micro enterprises were not registered, and the “grey economy” continues to be very important in the region today. Research conducted in 1999 under PBEP on the market for credit guarantees indicated that a total of 46,963 SMEs employing 1,250 people operated in LFP’s area of operations, but projections indicated that the number of potential clients could increase to over 80,000 by 2003.

**Operations**

LFP defines an SME in accordance with Polish law, mainly on the basis of the number of employees (micro enterprises are those with 5 employees or less; small have 50 employees or less; and medium have 250 or less), although turnover and total assets are also taken into account in the legal definition. To qualify, SMEs...
must be located in the region, have been in business for at least 6 months, be at least 51 percent Polish and privately owned and operate in any sector with the exception of primary agriculture, weapons, tobacco and distilling.

At the start of the project, credit guarantee policies and procedures were put in place by PBEP project advisers, and these remain largely in place today. LSP guarantees both working capital and investment loans in Polish and foreign currency. The guarantee limit is currently PLN 300,000 and a maximum risk share of 70 percent of loan principal. There is no limit to the loan size. The minimum guarantee size is PLN 15,000. On average, guarantees are around PLN 85,000 with a risk share of 55 percent, and loans have an average duration of 15 months. LFP fixes its commission charge based on the risk of the guarantee, its operating costs and the degree of acceptance of charges in the market. Maximum charge is 1.5 percent of the guarantee value per annum, and was on average 1.4 percent in 2004. This is a substantial decrease from the charges levied in LFP’s early days, which were up to 3 percent.

At first the very conservative banks in Poland were extremely cautious with what was then the new guarantee instrument, to the point where it made it difficult for credit guarantee funds to operate. Initially, banks insisted on having one for one cash deposit coverage of each guarantee, with some banks blocking the deposit for the duration of the loan. To prevent wasting time on management of capital between a number of banks, LFP developed a mechanism whereby most of the capital was kept in one bank (which also led to improved returns on investment), which would then issue Letter of Credit to lending banks to secure loans. While an improvement on provision of cash deposits as security, such a conservative approach by LFP’s partner banks delayed the development of a significant multiplier: at end 2000 the multiplier was still only 0.97 (that is, guarantees remained slightly less than total capital). It is interesting to note that partner banks began to grant loans against guarantees that were in excess of Letters of Credit opened in their favour, sometimes up to 2.5 times, which meant that a multiplier was achieved, at least with some individual banks.

From an initial six partner banks, LFP has expanded its cooperation to 16 partner banks operating in the region, which constitute most of the banks lending to SMEs. LFP’s guarantee terms and conditions are the same for all its partner banks, and the cooperation agreement specifies a maximum multiplier of 3.0 on LFP’s funds.

Applicants for loans from banks who cannot provide sufficient security can apply to have their loan guaranteed by LFP. Following approval of the loan (which is conditional upon provision of a guarantee), the bank forwards the guarantee request to LFP. A response is provided within 14 days, during which time LFP staff meet the applicant, assess the business and the financial and legal situation and provide a decision. Applicants can also directly approach LFP branch offices established in local development offices in towns in the region. This is an important conduit to LFP services for those clients who are apprehensive of using bank services and may not be aware of the existence of LFP.

operations not exceeding the PLN equivalent of Euro 7 million or assets at the end of that year less than PLN equivalent of Euro 5 million. A medium enterprise is one that is not a small enterprise and in the previous financial year: 1) employed less than 250 employees on average over the year and 2) had net income from sale of articles, products and services and financial operations not exceeding the PLN equivalent of Euro 40 million or assets at the end of that year less than PLN equivalent of Euro 27 million.
From start-up of operations to the end of 2002, LFP issued 650 loan guarantees for almost PLN 90 million, making it the top performing regional/local guarantee fund in Poland. LFP offers training programmes for bank staff on loan guarantee procedures. In addition, LFP disseminates information on its services by participating in conferences, seminars and other events.

LFP has found that there is a direct relationship between the performance of the economy generally and the performance of its guarantee portfolio. Between 1998 and 2000 there was an economic boom in Poland: many SMEs started up and LFP issued PLN135.4 million in guarantees with no losses. Since 2000 the economy has been depressed, with the result that applications and approvals have decreased steadily.

Table 2 LFP Performance

<table>
<thead>
<tr>
<th>Year</th>
<th>95</th>
<th>96</th>
<th>97</th>
<th>98</th>
<th>99</th>
<th>00</th>
<th>01</th>
<th>02</th>
<th>03</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of applications</td>
<td>135</td>
<td>116</td>
<td>111</td>
<td>98</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Number of guarantees issued</td>
<td>6</td>
<td>57</td>
<td>80</td>
<td>93</td>
<td>111</td>
<td>121</td>
<td>98</td>
<td>91</td>
<td>90</td>
</tr>
<tr>
<td>Guarantees issued (PLN millions)</td>
<td>0.329</td>
<td>3.17</td>
<td>5.60</td>
<td>6.63</td>
<td>10.00</td>
<td>7.81</td>
<td>8.04</td>
<td>8.00</td>
<td>9.44</td>
</tr>
<tr>
<td>Average guarantee (PLN’000)</td>
<td>54.8</td>
<td>55.6</td>
<td>70.0</td>
<td>71.3</td>
<td>90.1</td>
<td>64.5</td>
<td>82.0</td>
<td>87.9</td>
<td>104.9</td>
</tr>
<tr>
<td>Defaults (PLN million)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>0.028</td>
<td>0.046</td>
<td>0.091</td>
<td>0.199</td>
<td>0.151</td>
<td>0.196</td>
</tr>
</tbody>
</table>

Cumulative repayment ratio since inception is 98.8 percent. Guarantees outstanding to LFP’s 16 partner banks were PLN 115.7 million at 30 June 2004. The two most active banks account for 73 percent by number and 68 percent by value of all guarantees issued since inception, and 64.5 percent by number and 46 percent by value of guarantees outstanding at end June 2004. These two most active banks, together with two much less active banks, were interviewed.

As at the end of 2000, working capital loans made up 83 percent of the LFP portfolio, with investment loans constituting the remaining 17 percent. By the end of 2003, working capital loans had declined to 65 percent, with a corresponding increase in investment loans. Credit for manufacturing enterprises declined from 22 to 13 percent in the same period (perhaps because manufacturing SMEs have assets that can be pledged), while credit for trade enterprises increased from 45 to 55 percent and services remained constant at about 33 percent.
Findings

Assessment of the CGS

Design Philosophy and Strategic Approach

LFP states that bank policies toward the sector tend to change from year to year depending primarily on economic conditions. LFP perceives that, when conditions are poor, the banks are very quick to tighten requirements and decrease lending. When conditions improve, it takes more time to ease conditions and increase lending. LFP stated that banks desire guarantees to support SME loans when conditions are bad, but when conditions improve they tend to lend to SMEs without any guarantees at all. It was interesting that banks perceive that the level of SME business fluctuates directly with economic conditions. When the economy is poor, they have difficulty in finding new SME business of acceptable quality.

LFP finds that entrepreneurs do not generally borrow to establish their enterprises. This means there is little demand for loans, and thus guarantees, for SME start-ups. When local authorities provide funds for this express purpose, LFP will provide guarantees for start-ups. LFP’s perception is that banks are generally not interested in SME start-ups. LFP is finding that small loan funds, with lower cost structures and intimate knowledge of local markets, are efficient at lending to SMEs and are taking some SME business away from the banks. LFP believes that these are its natural partners for supporting start-ups.

At the start, LFP clearly recognised the importance played by senior bank managers, as in the first factor, “an influential champion within the lenders”. Their connection with the highest level of the bank’s structure was assisted by the fact that the banks were, at that time, regional in nature. Three banks were founding shareholders of LDF and so were easily approached regarding the CGS. Subsequently, LFP has lost at least some of those top-level relationships. However, relations at lower, operating levels are still critical, and LFP works to preserve these. The banks’ lending managers and loan officers have targets for lending, and LFP is seen as a tool that can help achieve those targets. However, it can sometimes be easier for loan officers to book mortgages, for example, rather than arrange a guaranteed loan to an SME.

Close cooperation between LFP and the banks is maintained through monthly reporting from banks to LFP on repayments, regular marketing meetings, and almost daily telephone conversations with credit officers. Maintenance of these contacts is inhibited by the high turnover in bank personnel extant in the banking sector generally. Banks did not seem to find the reporting regime an excessive burden.

The approach of LFP strongly reflects the second, third and fourth success factors of our thesis. It has taken the “financial sector approach” from the start of its existence; it has an understanding and empathy with market forces, and it has a long term approach emphasising institutional and financial stability. While credit guarantees were little known and understood when LFP started operations, the concept is very well known and understood today. LFP served as the pioneer for credit guarantees in the Lublin region in the 1990s, however this role has diminished to the point where the banks perceive that LFP offers a commodity-type service that is distinguished from that of other CGS only in its details, such as the commission charged. It is interesting to note that 9 years ago LFP refused almost 10 percent of applications, but now refuses only about 2 to 3 percent.
There is no evidence of transfer of appropriate lending technology to banks currently, as in our fifth factor for success. All the banks interviewed said that the technology of lending to SMEs was well established. In many cases, such technology was imported from a foreign bank when it became a shareholder: the banks tend to view it as proprietary. Only those that were involved in credit guarantees a decade ago recall the role of LFP in this area.

While 3 banks are founders of LDF, the structure of LFP as a subsidiary company wholly owned by LDF does not allow the partner banks a consultative or directive role in line with the sixth success factor of the study thesis.

**Partner Banks**

All banks interviewed indicated that the SME sector was profitable and that the risk was no greater than in other sectors. All banks indicated that its SME business was more profitable than that with large companies, where profit margins are very slim. The SME sector is growing at a substantially higher rate than the corporate sector.

The reasons given by the partner banks interviewed for cooperation with LFP included: the potential for increasing lending and utilisation of liquidity, both to existing and new clients that were bankable but had insufficient collateral security; and increase in market share in an increasingly important sector. Competition between banks for business in the SME sector is intensive and the CGS is a means for increasing or maintaining competitive advantage. Interest in credit guarantees by SME clients is increasing. It is clear that the issue of credit guarantees is seen as a commercial issue by the banks. None of the banks stated that they decided to cooperate with LFP to support the country’s development programme or to comply with the Government’s social initiative. This matches the general attitude of banks in Poland, which is very independent of government.

Banks that had their headquarters in Lublin when the initial relationship with LFP was established acknowledge that it would be much more difficult to establish such a relationship today, when the headquarters is in Warsaw.

An advantage of LDF over other CGS, from the banks' perspective, is that LFP tends to be more flexible with respect to loan purpose than other options. The banks agreed that there will always be a need for a credit guarantee fund because there will always be a proportion of clients that cannot provide sufficient security. These clients may grow to be large clients some day, so cooperating with LFP today helps the banks build the profitable portfolios of tomorrow. Also, companies in eastern Poland tend to be smaller: if SMEs were excluded from the banks’ portfolio they would be hard pressed to justify their presence in the business market in Lublin Voivodship.

One bank interviewed stated that the role of LFP was important when it started operations, when the bank was afraid to lend to any SME without a guarantee. Now LFP is more marginal to the bank as credit guarantees are used only in those instances where viable clients lack sufficient security. Another bank indicated that guarantee clients represent less than 5 percent of total SME clients. It appears that many, if not most, guarantee clients are new clients to the banks, and although they are mainly existing enterprises, some are start-ups or have been in business only a short time and have insufficient assets to serve as security. One bank estimated that approximately 5 percent of its business conducted with a guarantee was with start-ups.
During the past few years, there have been changes to terms and conditions to SMEs in the banks interviewed. Banks in Poland are now viewing the SME sector as a serious target market, and in some cases are now offering the same terms and conditions to SMEs as to larger corporate borrowers: for example, investment loan duration has increased to a maximum of 10 years. On the other hand, there are special approaches for handling SMEs, such as simplified procedures for SMEs borrowing small amounts. SME clients are becoming more sophisticated and competition is keen on the basis of the level of service as well as the price.

Several of the banks interviewed have explicit bank strategy statements indicating that they will increase their exposure to the SME market. These banks reported that the situation is similar in many other Polish banks: they have been restructured, adopting Western European objectives; sales functions are being separated from risk analysis; and new technology including credit scoring methods have been introduced to serve small clients cost effectively. They felt that the sector had matured and that it is well served by the banking sector today.

If anything, banks are currently showing a dramatically increased interest in SMEs, mainly because of large amounts of EU structural funds that will be allocated to Poland. Banks are planning marketing strategies that target SMEs that are both implementers and beneficiaries of projects funded by EU structural funds. Competition in this market for SME business is likely to be extremely high.11

Some of the banks interviewed indicated that they have an existing relationship with the national CGS. They reported that their procedures are easier and that their charges to the client are less.

Banks interviewed stated that, without LFP guarantees, some SME clients would be unable to obtain loans. However, none provided an estimate of the likely numbers of SMEs that would be unable to obtain credit, or the decrease in SME lending that would result from an end to LFP's operations.

**Negative Evidence**

None of the banks interviewed cited any negative effects from LFP operations. Our observations indicated that the conditions attached to the scheme had not resulted in any significant distortions in the market place.

**Summary**

The assessment of LFP against our micro factors for success and failure is set out in Table 3.

### Table 3 Assessment of CGC against Factors for Success

<table>
<thead>
<tr>
<th>Factors for Success</th>
<th>Factors for Failure</th>
<th>Assessment12</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>1</td>
</tr>
<tr>
<td>Micro Factors</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

11 Coincidently, LDF has been designated by the Lublin Marshall’s Office as the managing agent for structural funds projects in the Voivodship.
12 Where 1 = “very much so”; 2 = “to some extent”; 3 = “only slightly”; 4 = “not at all”.

A8.13
Factors for Success | Factors for Failure | Assessment
--- | --- | ---
1. An influential “champion” (or champions) within the lender(s) who actively promotes the CGS for appropriate commercial reasons; | • Lack of support or lack of understanding of the commercial logic of the CGS within the lender(s); | √
2. A “financial sector” approach to CGS design that focuses on the goal of achieving a permanent deepening of the financial sector; | • A “social sector” approach that focuses exclusively on a short-term goal of pushing finance to the SME sector and the use of financial institutions as conduits for that purpose; | √
3. An understanding of and empathy with market forces, particularly for providers of financial intermediation services; | • An emphasis on the social obligation of lenders or compliance with laws, regulations or policies | √
4. A long-term approach that emphasises institutional and financial sustainability, with objectives directly related to financial sector deepening, even if project interventions are short or medium term in duration; | • A project approach that focuses on short-term objectives that are limited to the period of the project intervention, rather than directly related to long-term financial sector deepening; | √
5. Extensive transfer of appropriate lending “technology” in terms of policies, procedures, methodologies and systems through carefully focused technical assistance; | • Reliance on targets for achievement of project lending objectives without regard for the ongoing sustainability of institutional processes; | √
6. A participative approach that achieves a balanced partnership between donors, CGS and lenders for achievement of agreed objectives; | • A paternalistic approach that imposes a CGS project on reluctant lenders who do not understand or do not agree with the stated objectives; | √
7. Ownership by lenders of the CGS stemming from clear and significant benefits to lenders in terms of assistance to open up new markets for profitable commercial exploitation. | • Coercion of lenders through a “carrot” (non-transparent benefits unrelated to financial sector deepening) and/or “stick” (pressure from political or regulatory authorities) approach. | √

Overall Financial Deepening Performance and Impact

LFP management itself thinks that LFP is not large enough to make a significant impact on banks’ attitudes to the SME sector. At the beginning of LFP, when they were issuing 5 to 8 guarantees per year, they questioned the use of their guarantee activities. However, they now say that they are starting to see the results in an improvement in the region’s economic development. Naturally, LFP tends to measure its performance against other CGS active in the Poland context. LFP now issues 15 percent by number and 25 percent by value of all guarantees issued to support loans to SMEs in Poland. LFP has been used as a model by the national government and other credit guarantee companies.

LFP does not suggest that it has shared the cost to the banks of opening new markets, as it does not consider that it has experienced excessive calls against its...
guarantees. It sees its historical role more as having helped change the institutional attitude of the banks to SMEs. They feel that their efforts, combined with the growth of the SME sector, have helped improve the banks' attitudes to SMEs. There was a significant delay in achieving this change in attitude, but in the opinion of LFP, this was due to the restructuring and privatisation taking place in the banking sector, which focused banks' attention onto internal issues rather than external markets.

It is apparent that financial sector deepening has taken place in Poland over the past 10 years. The SME sector now has access to banking services, although many individual SMEs may still have difficulty accessing credit, particularly in less developed or economically disadvantaged areas such as the south-east. While it may be premature, we can envisage a time soon when, in some parts of Poland, the major market for CGS will be reduced to those SMEs that also have problems obtaining credit in the more developed western economies of the European Union.

The dilemma for this study is determining the extent to which the LFP contributed and continues to contribute to the changes observed, particularly given the extensive economic changes Poland has experienced during the past decade. Included in this has of course been its journey to EU accession, although in general most banks discounted the influence of this on the SME sector. More important had been the failure of the state owned industrial sector, which caused high unemployment and forced large numbers to become self-employed.

The question of causality is difficult, however it is our judgement that LFP made a significant contribution to financial sector deepening in the early years of its existence, particularly in the Lublin Voivodship. However, it is also our opinion that, due to the rapid changes taking place in the Polish economy, combined with a lack of continuous innovation in LFP’s credit guarantee mechanisms, LFP’s credit guarantee activities are now marginal in their influence on financial sector deepening.

Suggestions for Improvement

Given the fairly advanced state of SME banking in Poland today, the checks that LFP undertake following bank screening seem excessive and is not justified by the historical bad debt experience. The maximum 14 days that it takes to complete LFP checking procedures represents a significant extension of the approval period and reducing the checks that LFP carries out would seem to bring positive benefits.

In this regard, there are two positive steps that LDP could consider. First, they could copy the procedures of the National CGS, which leave guarantees below a certain threshold (currently PLN 200,000) to the discretion of the partner bank. Second, and more radically, LFP could leapfrog the current CGS industry in Poland by introducing a portfolio guarantee system, for selected partner banks with particularly good SME lending records, whereby all loans in a portfolio that maintains certain set characteristics are automatically guaranteed. This has the potential to dramatically reduce processing time and cost and dramatically distinguish LFP from the competition.

Banks interviewed indicated that the current upper limit on guarantees no longer corresponds to the credit needs of SMEs. LFP may wish to examine this issue with a view to increasing its maximum guarantee size.
# Summary Characteristics of CGS Studied

<table>
<thead>
<tr>
<th>Characteristic</th>
<th>Fogape - Chile</th>
<th>CGC - Egypt</th>
<th>CGTSI - India</th>
<th>LDF - Poland</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Approximately US$ 310m loans guaranteed in 2003.</td>
<td>- outstanding guarantees at year end 2003: US$ 24.7m.</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>- outstanding guarantees at year end 2003: US$ 34m loans guaranteed in 2003.</td>
<td></td>
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<td>Health Care Providers (HCP) Programme:</td>
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<td>- outstanding guarantees at year end 2003 US$ 19.25m.</td>
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<td>- approximately US$ 9m loans guaranteed in 2003</td>
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<td></td>
<td>30,000 transactions in 2003</td>
<td>Approximately 3,000 guarantee transactions per year total under SME and HCP Programmes, representing outreach to about 3% of SMEs</td>
<td>6,600 transactions in the year to March 2004</td>
<td>90 guarantees issued for US$ 2.6m in 2003.</td>
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<td><strong>Scale</strong></td>
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Since inception:
- guarantees issued represent 15% by number and 25% by value of all guarantees issued to support loans to SMEs in Poland.
- the 2 most active banks account for 73% by number and 68% by value of all guarantees issued.
<table>
<thead>
<tr>
<th>Pricing of major product</th>
<th>Commission was set at 1% per annum of the guarantee, but since June 2004 it has been increased to a range of between 1% and 2% depending on the claims performance of the bank concerned.</th>
<th>SME Fund: 2% of the guaranteed loan amount. HCP Programme: 2% annually of the highest debit balance of each NGO overdraft account in case of lending through NGOs</th>
<th>2.5% of loan initial fee, plus 1% per annum service fee on outstanding loan amount</th>
<th>Commission charge is based on the risk of the guarantee, operating costs and the degree of acceptance of charges in the market. Maximum charge: 1.5% of guarantee value per annum. Average charge: 1.4% in 2004 (reduced from 2.5% to 3.0% at inception).</th>
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<tr>
<td>Risk Coverage</td>
<td>Maximum risk coverage is now normally 70%. However, one third of its capacity, directed at term loans over three years and loans to exporters and emerging enterprises (less than 3 years of age), is allowed to go up to 80%, with a maximum limit of credits with Fogape of US$ 130,000. Average risk coverage: 71% in 2003, down from 79% in 2001.</td>
<td>SME Fund: Up to 50% of loan principal. Average guarantee is 41.3% HCP Programme: 100% of loans up to US$ 61,500; and 65-75% of bigger loans. Average coverage is 83%</td>
<td>Risk coverage is 75%, with 2 year minimum before a claim is allowed. Only 75% is paid out on approval of a claim, with the balance paid at the end of the recovery process. Maximum loan US$ 55,000</td>
<td>Maximum coverage: 70% of loan principal. Guarantee maximum limit US$ 10,000. No limit to loan size. Average risk share: 55%; loans average duration of 15 months.</td>
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<tr>
<td>Multiplier</td>
<td>Maximum 10:1 (late 2004 near the maximum)</td>
<td>Actual multipliers: - SME Fund: 2.2:1 at end of 2003 - HP Programme: 1.5:1 at end of 2003</td>
<td>No maximum formally set, but possibly 5:1</td>
<td>Current cooperation agreement specifies maximum multiplier of 3:1. At end 2000: 0.97:1 (i.e. guarantees were less than capital).</td>
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<tr>
<td>Provisioning Policy</td>
<td>Approximately 4% of the outstanding guarantee portfolio (2004)</td>
<td>The current level of provisions is approximately 4.9% of the outstanding guarantee portfolio.</td>
<td>Initially 27% of outstanding guarantee portfolio (first 2 years of scheme)</td>
<td>N/A.</td>
</tr>
</tbody>
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1 Based on current exchange rate: 1 US Dollar (USD) = 3.00060 Polish Zloty (PLN).
### Bad debt experience

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<tr>
<th>Claims paid out at 1.04 to 1.28% of the average outstanding guarantee portfolio per annum in the years 2001-03. The default rate, net of recoveries, after three years, is a total of 2.5%.</th>
</tr>
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</table>

### Net cumulative loss experience:

- **SME Fund:** 1.44\% of guarantees issued i.e. US$ 1.9m (by end 2003)
- **HCP Programme:** 1.0\% of guarantees issued i.e. US$ 0.91m (up to end 2\textsuperscript{nd} quarter 2004)
- Average cumulative repayment ratio for all guarantee funds: 97\% by end 2003

### Too early to judge because of 2 year lock-out on claims

### Cumulative repayment ratio since inception: 98.8\% 

### Indication of Financial Sustainability

<table>
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<tr>
<th>Fund capital US $47m provides investment income which together with net operational profit/loss and administration costs has resulted in small losses in 2002 and 2003, after profits in 2000 and 2001. Fund capital being maintained long-term but not organically increased.</th>
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<th>Each fund is accounted for as a separate profit centre, and any excess after provisions is often added to fund capital. CGC produced small profits in 2002 and 2003.</th>
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<tr>
<th>Fund capital initial tranche US$155m with commitment up to US $550m announced. Financial model allows for high default rate, but long term stability through some appropriation of investment income</th>
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<th>LDF is not a profit-oriented organisation, but financial self-sustainability is a goal of the LDF and its subsidiaries. This dichotomy is achieved by defining self-sustainability as including income from project funds, which covers those services that LDF delivers at below cost prices. LDF is not &quot;subsidised&quot; by either local authorities or the government, although local authorities may choose to &quot;invest&quot; in LDF activities to achieve a social return.</th>
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</table>
Credit Guarantee Schemes for Small Business Lending: A Global Perspective was published in 1997 by Graham Bannock and Partners Ltd. The report provides an overview of the global experience of credit guarantee schemes to this date, through the development of a classification covering the characteristics and performance indicators of schemes, and use of this classification to compile a global directory of credit guarantee schemes. The ODA-funded study arose from the perceived need to reconcile the widespread use of subsidies to support credit guarantee schemes, both in developed and developing economies, with the continued questioning of the relevance and justification for such schemes and a persisting view among donor agencies that in general they do not have a successful record and can perhaps cause more harm than good. An additional issue was raised by the transformation of some successful microfinance institutions into banks, causing many to argue that it would be better to encourage this process rather than develop a mechanism to encourage formal sector banks to make loans to SMEs by supporting these loans with guarantees. The effects of such issues on traditional approaches to loans and guarantee mechanisms led ODA to commission this overview of global credit guarantee schemes, in order to inform any future policy debates in this area.

The aims of this study were to:

- develop a classification covering characteristics and performance indicators of credit guarantee schemes, using literature reviews, desk research and discussions with organisations that have supported the schemes; and

- use the classification to: collect, using a faxed questionnaire, summary data to assemble a global directory of schemes; and create a basis for carrying out in-depth studies, through field visits, of a selection of schemes in developing and transition economies and focusing in particular on the financial, economic and institutional context in which these were operating.

The study focused on the development of relationships between commercial banks and SMEs, and whether credit guarantee schemes could contribute to this process. It also looked at domestic institution building for financial capacity widening and deepening and how this relates to locally constituted guarantee organisations and funds.

The report begins with a detailed overview of the subject of credit guarantee schemes, outlining their objectives, costs and benefits, and the importance of the environment in which they are located. The issue of evaluation of schemes is also introduced. The report subsequently enters into the detail of creating a typology of credit guarantee schemes, identifying four major dimensions that form the basis of the typology:

- the financial instrument target;
- the enterprise group target;
- the form of organisation and type of funding; and
- the delivery mechanism.
Within these dimensions the report highlights a number of sub-types, which are examined in further detail. This study focuses on a sub-set of schemes which:

- focus on guaranteeing fixed and working capital loans from financial institutions;
- are orientated towards small and medium sized firms, not microenterprises;
- where the objective includes establishing domestic guarantee capacity as part of financial institution building within a competitive market place; and
- where delivery mechanisms enable a high level of activity without risking financial problems.

Subsequent sections of the report describe in greater detail design and organisational features that are appropriate for successful credit guarantee schemes. Firstly the general conditions for an effective and sustainable guarantee mechanism are highlighted, which set the basis for a chapter using insights gained from survey data, field visits and other analyses that give practical guidance on credit guarantee scheme design. The chapter considers a number of relevant issues to consider when designing appropriate schemes, including: eligibility criteria (borrowers); risk sharing; delivery mechanisms; governance of guarantee organisation; composition of guarantee fund; and fee structures. The report also examines various operational features of guarantee schemes, and highlights best practice principles under the following headings:

- marketing the guarantee service to lenders and to SMEs;
- approving applications;
- claims handling;
- interest element in claims;
- post-claim cost recovery; and
- managing guarantor-lender relations.

Finally the study considers the issues of performance standards and evaluation of credit guarantee schemes. Three possible methods are examined in turn: cost-benefit analysis, financial performance, and financial sector technical progress. It is argued that, in most cases, several complementary approaches are required and that the environmental context and managerial resources must be taken into account when making judgements on such schemes.

The report concludes with an overview of the efficacy of credit guarantee schemes and recommendations on design principles, key parameters and best practice guidelines. Despite considerable criticism of credit guarantee schemes, it is argued that many lessons have been learned throughout the history of the schemes, and that benefits can be considerable and costs controlled if the schemes are well designed and implemented. The study therefore argues that there is a role for credit guarantee schemes that act as a third-party sharer and facilitator of risk.