Commercial banks consider lending to farmers or rural micro and small enterprises (MSEs) risky. This is compounded by the fact that small-scale farmers and rural MSEs often cannot provide adequate collateral. Recently, however, there has been a resurgence of interest in credit guarantee systems (CGSs) for agricultural and rural enterprise development. On the one hand, CGSs improve the access of farmers and small agri-businesses to finance while compensating the lender for much of the risk should the borrower default. On the other hand, they may reduce the incentives of lenders and borrowers to diligently monitor loan investments and ensure repayment. In addition, the financial sustainability of guarantee funds is questionable given that most experiences reflect a dependency on government and donor subsidies.

This brief discusses the different types of CGSs and considers their application to and impacts on agricultural and rural enterprise development, emphasizing financial performance and sustainability. It also draws some lessons in the design and management of CGSs and concludes by making policy recommendations. The analysis is based on a study conducted by FAO on 16 case studies of guarantee funds in Africa, Latin America, Asia and Eastern Europe. These include, among others, the Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) in India, the Agriculture Credit Guarantee Scheme Fund (ACGSF) in Nigeria, the Estonian Rural Development Foundation, and the Fideicomisos Instituídos en Relación con la Agricultura (FIRA) in Mexico.

Credit guarantee systems for agriculture and rural enterprise development: appraisal and sustainability lessons
Types of guarantees

A CGS is any scheme under which guarantees are provided to investments according to certain conditions of duration, amount, nature of transaction, the type or size of the enterprise such as MSEs which often lack the kind of collateral required by banks. There are four main types of guarantees: (1) individual guarantees that provide partial coverage on the underlying principal loan amount with both borrower and lender clearly identified; (2) a guarantee directed at an investment facility is normally employed when a developing economy already has functional capital markets in place, and medium to long term placements of investment funds need to be generated; (3) portfolio guarantees in which lending to a specified priority development sector is supported by providing a partial guarantee for a number of loans (one lender, many borrowers); (4) portable guarantees where one specific and identified borrower is given access to a guarantee and can then compare competing loan terms and offers from various lenders. However, this type of guarantee has the disadvantage of relatively high transaction costs for borrowers and lenders when dealing with new applications.

Finally, an adequate sharing of risk between guarantor, lender and borrower that avoids moral hazard; fast and trustworthy claim procedures, and fee arrangements that encourage guaranteed loan repayment have a bearing on a CGSs’ market acceptance by lenders and borrowers and on their eventual success.

A recommended set of aspects to be jointly evaluated in analyzing the performance of CGSs include: (1) the guarantee fund’s clarity of purpose of guarantee; (2) leverage (i.e. value of credit generated per unit value of the guarantee fund); (3) governance and management; (4) geographical coverage; (5) targeted borrowers; and (6) eligible financial services providers.

The type of CGS prevailing in the sample studied is that of individual guarantees (see Figure 1). Recently, however, there has been a shift towards portfolio and specialized types of guarantees and away from individual guarantees. In general, newer forms of portfolio guarantees and those given to profitable sectors appear to perform better, by allowing greater value credit leveraged by the unused guarantee. Though national public and international funds remain the major contributor to guarantee funds, there is a trend to operate guarantee systems through specialized legal entities with limited political influence.

Pitfalls of credit guarantee systems

The common argument against CGSs relates to moral hazard issues stemming from the fact that CGSs weaken the will and commitment of the borrowers to repay the loan given that they know that a guarantee fund will reimburse the lending institution. However, this threat could be reduced if borrowers value access to specific types of credit products that would otherwise be denied if they failed to repay.

Lack of transparency in the presentation of financial results of most CGSs contributes to their fragility and potential misuse due to political influence that often diverges from commercial or development interests. The experiences of the Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) in India attest to this point. However, sound governance and autonomy has been achieved in other experiences, such as that of the Rural Development Foundation in Estonia.
a. Fideicomisos Instituidos en Relación con la Agricultura (FIRA), Mexico
b. Credit Guarantee Fund Trust for Micro and Small Enterprises
c. Agricultural Credit Guarantee Scheme Fund (ACGSSF), Nigeria
d. Rural Development Foundation, Estonia
e. Italian State Guarantee Fund for Agricultural Credit (ISMEA), Italy
f. Société de Cautionnement Mutuel du Sénégal, Senegal
g. Société Financière de Garantie Interbancaire du Burkina, (SOFIGIB), Burkina Faso
h. Rural Credit Guarantee Fund, Lithuania
i. Guarantee Fund Republic Srbska, Republica Srbska
j. Private Agriculture Sector Support Program (CGTMSE), India (PASS TANZANIA Ltd.), Tanzania
k. Bank of Tanzania, Credit Guarantee Scheme for SME (BOT SME CGS), Tanzania
l. Financial Sector Deepening Trust (FSDT), Tanzania
m. Agribusiness Loan Guarantee Company (ALGC), Uganda
n. Sustainable Agricultural Guarantee Fund (SAGF), The Netherlands
o. Société Tunisienne de Garantie (SOTUGAR), Tunisie
p. USAID Development Credit Authority (DCA)

Another weakness is inadequate supervision of banks and screening of ultimate borrowers resulting in loss of money and, in extreme cases, in the collapse of the guarantee system, as was the case with the Japanese guarantee system.

**Good practices in the design of guarantee schemes**

A well-designed, well-funded and well-implemented CGS can improve SMEs’ access to credit and help them to integrate into formal financial markets which enables them to improve their competitiveness and expand their economic activities. Box 1 below summarizes the main lessons for the design and implementation of CGSs.

Other key recommendations in the design and implementation of a successful CGS include: guarantee coverage should extend to the principal only or to a maximum of six months interest with the same risk-sharing proportion as the principal, adoption of flexible mechanisms for adjusting guarantee agreement components with lenders and borrowers, keeping management and supervision at arm’s length from politics, and the development of the management information system according to a transparent and comprehensive set of parameters reflecting the CGS’ goals.

Recommendations for operating and implementation procedures include determining fee levels on the basis of expected defaults and overall interest rate levels in the domestic financial sector. It is also important to design pending claims to ensure that claim submission is not premature. Finally, the rate of default of the underlying credit guarantee portfolio (i.e. the net claim) should not exceed 3 percent at least five years into scheme implementation.

Innovations and good practices in the design and management of CGSs focus mainly on institutional upgrading of credit schemes such as the tendency for national and stand-alone facilities, professional management of programme funds with limited scope for political interference, and facilitation through a network and branches of the guarantee fund provider (e.g. Mexico’s FIRA). Additionally, there is a tendency to invest funds directly as cash deposits in partner financial institutions in developing economies, without the involvement of international banking intermediaries, and a tendency to separate individual loan guarantees and portfolio coverage.

**Sustainability lessons**

Sustainability discussions are at the forefront of the debate on credit guarantee schemes. Sustainability of CGS hinges largely on having low defaults of the loan portfolio and low overall administrative costs. However, political interference may in some cases get in the way of sustainability. Government and political objectives are often different from those of guarantee fund managers, agribusinesses and bankers.

Recent experiences show that designing guarantee funds in a way that avoids blanket or easy loss indemnification can mitigate unsustainable losses. In this regard, a well-functioning national level credit reference bureau acts as a watchdog for sound guarantor agreements and compliance, and improves sustainability prospects of bank loan portfolio and guarantee funds.

While start up subsidies and adequate initial capitalization of CGSs are certainly required and justified, contemporary views recommend phasing out this support as soon as possible in order to avoid a situation where operating losses have to be offset by repeated fund injections.
Box 1. MAIN LESSONS FOR CGS DESIGN AND IMPLEMENTATION

a. Start with simple guarantee systems.

b. Knowing your client is key at two levels: guarantors to financial institutions and then financial institutions to farmers or agro-enterprises.

c. Increase access to agribusiness finance by lending money to agricultural financial institutions and backing guarantees. (e.g. Estonia RDF)

d. Understand the context and tailor products accordingly.

e. Set up disaster management systems to deal with financial and market shocks.

f. Understand how credit guarantees are connected to market and weather related risks.

g. Provide full funding to an established credit scheme in order to sustain growth requirements.

h. Manage claims and claim processes efficiently.

i. Risk management by the financial institution must ensure proper research of the value chains involved. (e.g. Crédit Agricole)

j. Allow for a governance structure that reduces the risk of political influence in operations.

The standard approach of shared guarantee funds requires a lower cash engagement on the guarantor side and a shared risk management on the lending banks side. In this regard the International Finance Corporation (IFC) advises against acceptance of first loss by the guarantor as it may lead to quick fund depletion.

FIRA’s experiences suggest that sustainability requires a long-term view and an institutional perspective, which is best paired with social objectives. Institutional sustainability of CGSs can be measured in terms of the maintenance of the real capital value of funds invested in the schemes. These funds should be managed without annual budget increments from the public treasury.

Past experience highlights the importance of initiating legal processes from the onset (e.g. foreclosure of loan, liquidation of collateral). Moreover, the performance of CGSs also depends on the extent to which guarantee fund staff has informational advantages with respect to borrower appraisal. In this regard, trust building across the tripartite relationship between the guarantee fund, lending institution and final borrower reduces risks and appraisal costs.

Concluding remarks

Risk sharing mechanisms have regained prominence in development finance because they have the potential to redirect excess liquidity in the banking system towards profitable but underserved agribusiness sector. In these cases, the informational restrictions faced by lenders can be reduced through lowering their exposure to risk while facilitating them with knowledge on these agribusiness sectors. The establishment of CGSs has the potential to spark this process between lender and the agricultural sector with measurable effectiveness.

Over the past two decades, CGSs in developing countries have undergone important re-structuring and have achieved medium term sustainability because of efficiency gains and improved scheme design.

Efforts have to be invested in building a co-operative relationship between guarantor and lenders in order to reduce the threat of moral hazard. Lenders have tended not to trust government-supported credit guarantee systems and have lacked confidence that the guarantees will be paid out quickly when a claim is made. New experiences are showing that CGSs can successfully develop the necessary collaborative relationships to overcome this.

Recommended readings
