

Chapter 2

SOME EXPERIENCES OF GUARANTEE FUNDS

This chapter presents some experiences of guarantee funds. The literature on this subject is quite rich; a thorough presentation of international experiences in this report would go beyond the scope of this work and would not be very fruitful as the relevant literature is easily accessible (see the list of references in this respect). Rather, a sample of case studies is presented, taking one country for each area of the world; the choice of the case studies has been made according to two criteria: their relation to the agricultural sector or the presence of particularly interesting aspects in their operations.

The following Country case studies are retained:

Western Europe: Italy

Central and Eastern Europe: Poland

North America: U.S.A.

Latin America: Trinidad and Tobago

Africa: Senegal

Asia: Malaysia

2.1. WESTERN EUROPE: ITALY – FONDO INTERBANCARIO DI GARANZIA (INTERBANK GUARANTEE FUND)

The Italian Fondo Interbancario di Garanzia was consti-

tuted in 1961 and is included in the Italian banking law ¹. The Fund is a public institution whose Board of Directors is composed of a representative of the Ministry of Treasury (which has the control on the fund) and representatives of the banks offering agricultural credit that have shown the best performance in terms of contribution to the fund and loan recoveries for defaults covered by the fund ². The banks that want to be covered must pay a contribution (0.05 per cent of the loan amount) to the fund; they also withdraw from the customer the fee that he/she also has to pay to have the coverage (0.25 to 0.30 per cent of the loan amount) ³.

The guarantee is subsidiary, as banks are covered by the fund only after demonstrating that they have done their best to recover the loan by all means, and having executed the collateral. If the bank does not follow a correct and safe procedure in both the evaluation and the follow-up and recovery phases, the fund may refuse to intervene in case of default.

The fund is meant to cover agricultural and fishery loans. However, not all types of loans are covered even if the categories included have increased over time. While originally it only covered individual, medium and long-term loans, now the fund may cover:

- medium and long-term agricultural credit operations, for firm investments in real estates or machinery, at market or subsidised interest rates, for an individual amount comprised between Italian Lire 10 mln. and 3 bln. (approximately US\$ 5,000 to 1.5 mln.), maximum coverage may be 50 to 70 per

¹ The sources of the information in this paragraph are mainly the Fund itself, and the laws and regulations related to the fund establishment and functioning. Reported in Viganò (2000).

² Since 1994 the Italian banking system has fully de-specialised, and any commercial bank can grant agricultural credit. However, not all banks are now engaged in this sector.

³ Banks also pay a penalty in case the recovery rate is not satisfactory.

cent according to the type of loan. Potential beneficiaries are both individuals and co-operatives, or companies with a participation of agricultural co-operatives.

– Short-term agricultural credit operations granted at subsidised interest rates for a maximum amount of Italian Lire 1.5 bln. (approximately equal to US\$800,000); if the amount is less than Italian Lire 200 mln. (approximately US\$100,000) the coverage is 50 per cent; beyond that amount, coverage is 30 per cent. No specific category of beneficiaries is indicated.

It should be noted that the percent coverage was much higher when the fund was established (80 to 100 per cent).

The original function of the fund was to support long-term agricultural investment combining the guarantee system with the subsidised credit measures provided by public authorities. In this way it created an incentive to banks to engage in the agricultural sector, allowing the subsidies to reach the farmers and, therefore, as it was intended and believed at that time ⁴, to support them through these public measures. The gradual extension of the coverage to short-term loans, when granted through public facilities at a subsidised interest rate, was probably meant to achieve the same purpose. However, this extension is now going to disappear again, following the elimination of interest rate subsidies on short-term loans by the European Union, which is now regulating agricultural promotion policies in Italy. Banks are urging the fund to consider the possibility of extending the facility to short-term loans at market rates but the fund, despite recognising the importance of extending its services, remains cautious on this issue.

In fact, the extension of the coverage to subsidised short-term loans and to co-operatives had put great pressure on the fund. Short-term loans requiring more frequent interventions

⁴ The conviction that cheap agricultural credit has distortion effects is now widespread.

for the coverage, and the co-operative sector being the highest risk in agriculture in Italy⁵, the Fund had gone through a financial crisis in recent years. Recently, it has been heavily re-capitalised for a total amount of Italian Lire 300 bln., 50 per cent from the Ministry of Treasury and 50 per cent from the participating banks. An eventual enlargement of its operations would require further capitalisation, which it would be difficult to achieve in the short run.

After 1996, the fund amount has been maintained over Lire 560 bln., approaching Lire 600 bln. recently, which is judged consistent with its current exposure. Besides the above-mentioned reduction in the percent coverage, the fund has become more rigorous with the beneficiary banks in recent years with respect to both the conditions to have access to the coverage and their reimbursement to the fund. In fact, despite the formal obligation they had, banks on average tended to adopt relatively soft measures in the process of recovering the amount overdue from customers by all means and, subsequently, passing this money over to the fund as a partial refund of the coverage that the fund had disbursed. This can be considered a typical case of moral hazard, as the banks that received the coverage were not encouraged to put pressure on the customers for reimbursement.

As stated, the fund current operations seem to be consistent with its financial equilibrium after re-capitalisation (the total amount of loans covered is now almost 13,000 bln. Lire). The fund management declares that the preservation of financial equilibrium will be a leading principle for the fund, in view of the negative consequences of the financial stress that the fund has suffered before re-capitalisation. However, a fu-

⁵ The average amount of the defaults covered by the fund was 46 mln. Lire in 1997 and increased up to 116 mln. Lire in 1998 due to the coverage of co-operative loans; co-operatives occupy an important place in the Fund's activities also in the following years (see Fondo Interbancario di Garanzia, 1999, 2000, 2001).

ture enlargement of operations is considered to be important to strengthen the impact of the fund on the economy, provided that it is consistent with the financial equilibrium and the economic viability of the fund itself. This should not imply increasing the percent coverage, but rather widening the range of the types of operations to be covered, also considering that the current typology of operations is going to have a more restricted impact.

In order to complete the picture, it is worth mentioning that in Italy there is another form of credit guarantee operating for agricultural loans, i.e. mutual co-operative agreements or farmers' consortiums. This kind of agreements is more widespread in non-agricultural sectors but there are some funds that are established specifically for the primary sector (Agrifidi). The mutual fund offers its guarantee to the financing bank by depositing a "risk fund" with it; meanwhile, the associates also offer a warranty to the bank. The loan application is usually submitted to the consortium, which forwards it to the bank; the bank makes its own decision on the application and is allowed to withdraw from the "risk fund" after notification of the insolvency to the consortium. The borrower has to pay a commission to the consortium and a fee to the bank for the application analysis.

While this form of guarantee is generally appreciated, operators highlight some shortcomings, namely the high level of the fees and commissions and the reduced transparency that may derive in the bank-customer relationship. In fact, the bank usually withdraws the commission and transfers it to the consortium, which makes it difficult for the borrower to know whether he/she is paying a fee to the consortium or to the bank. In this sense, some banks would prefer to propose that the customers pay a higher interest rate and give up the recourse to the consortium, while the banks themselves would take the whole risk of the operation. There are two other main criticisms to this form of consortium. The first refers to the

basic condition that there should be a strong common link between consortium members — which is not often the case even in Italy, where co-operation is quite diffused but not in all regions of the Country (Bottiglia, 1998); the second focuses on public subsidies to consortia, which may introduce distortion elements in the market.

2.2. CENTRAL AND ESTERN EUROPE: POLAND — THE CAPITAL ENHANCEMENT GUARANTEE (CEG)

Poland has a large number of diversified guarantee funds, some of which are public funds specifically operating for the agricultural sector (on loans for the purchase and storage of products, the purchase of land or other investments in the agricultural sector). Generally speaking, the whole set of guarantee systems in Poland is characterised by a low volume of operations, low leverage and high operating expenses (Gudger, 1998).

On behalf of the Ministry of Agriculture of Poland, FAO has developed a project for a new model of credit guarantee scheme. The idea was presented by Von Pischke ⁶.

The performance of many guarantee funds, in both industrialised and developing countries, is not always encouraging due to high costs, low volume of operations, low additionality, low incentives to banks to be involved and poor quality of loans. The proposal presented is meant to achieve the following goals:

- to actually encourage lending to the agricultural sector (additionality);
- to keep operating costs under control;
- to encourage sound banking practices and credit risk control.

⁶ This paragraph is a synthesis of what reported in Gudger (1998) who, in turn, reported his version of the original proposal by Von Pischke.

The system works as follows:

- Donors' and national funds are provided for auction as capital enhancement guarantees and placed in a special account at a fiduciary intermediary.

- The owner of the fund acts as guarantor.

- Possible owners may include: donors, the government, a trust or an official agency such as the Central Bank but no permanent guarantee organisation is established.

- The guarantor provides capital to participating banks through a bidding mechanism.

- The banks' bids must indicate the amount of additional capital needed to support a given amount of additional lending; the bid price is the ratio of additional capital to additional loans and successful bidders are those who offer the best leverage for guarantee capital.

- The owner transfers the guarantee capital to the successful banks in the form of a subordinated debt which converts into permanent capital at the end of three to five years.

- The interest applied on guaranteed loans is higher than average interest rate as it must cover the risk premium for higher-risk loans. The risk premium may be capitalised and auctioned periodically.

- Bidders' eligibility and their performance in making guarantees are monitored and unacceptable behaviours are sanctioned.

The main advantages of this method are:

- the decision-making responsibilities are transferred to banks;

- the system allows banks to develop greater skills in managing risk, creating permanent enhancement in risk management, improved credit policies and lending strategies;

- moral hazard is reduced or eliminated as banks have undiminished incentives for good credit decisions and loan administration;

- the auction process makes it impossible to direct guarantees to specific borrowers (except through collusion);
- the allocation is transparent and not subject to political influence but based on independent banker's evaluation of the viability and profitability of the loan;
- it is a market-based, risk-sensitive measure to direct subsidies to lenders and their clients which does not imply on-going budget subsidies for losses or administration costs over and above the initial amount required to create the fund;
- additionality is more likely to occur as the system offers the strongest possible incentives to banks to make additional loans that are consistent with prudent banking practices;
- donors' funds can be disbursed very quickly in the form of capital enhancement guarantees;
- administrative costs are trivial and the system requires almost no staff;
- no permanent guarantee organisation is created;
- there is no social loss, discontinuity or transition problems when the guarantee programme terminates as the guarantee funds remain at work in the banking system.

2.3. NORTH AMERICA: THE U.S. GUARANTEE INDUSTRY

As also reported by Gudger (1998), the commercial guarantee industry is very peculiar of the U.S. system as, contrary to what happens in many other industrialised countries, financial guarantees are offered as the sole product of some companies.

Two main components of the guarantee industry in the U.S. are (Gudger, 1998):

- mortgage guarantee companies, issuing financial guarantees on individual mortgages for those that cannot afford to offer the required down payment;
- bond guarantee companies providing coverage for the payment of capital and interest to holders of mutual bonds

and now also backing the securitization process, also related to pools of small-size loans.

In the second category, Farmer Mac, related to the Farm Credit Administration and established in 1987, operates to provide a guarantee of timely payment of principal and interest to holders of mortgage-backed securities of pools of agricultural real estate or rural housing loans. Farmer Mac has two programmes:

- Farmer Mac I, where either Farmer Mac or private institutions create mortgage-backed securities on agricultural loans and Farmer Mac provides the guarantee;

- Farmer Mac II, where lenders sell guaranteed portions of Farm Service Agency loans from which Farmer Mac creates securities.

In 1994, results of Farmer Mac I were not encouraging because the Farm Credit Banks that were supposed to pool the loans did not act in this direction and other competitors were developing similar programmes (Fannie Mae). This led Farmer Mac to establish a 5-year agreement with Western Farm Credit Banks in 1994, to create a national network with these banks for the purchase of pooled loans by the Farmer Mac⁷.

As Gudger (1998) stated, this kind of guarantees is hard to be imagined in the developing countries context, especially for micro-entrepreneurs. Even for SMEs, the potential market size of many countries would not allow the development of such guarantee mechanisms. Some potential for expansion is probably present in certain Latin American as well as Asian countries. Among the latter, it is worth mentioning the case of Asia (Asian Securitization and Infrastructure Assurance) Ltd., cited by Gudger, where a combination of development agencies, international insurers and re-insurers and specialised credit insurers contribute the capital of the company. In

⁷ Source: Farm Credit Administration (1994) and the web page: www.fca.gov.

fact, Gudger suggested that, in accordance with the origins of the U.S.A. model, governments and donors could first capitalise and assure a multinational market for these new companies until they reach adequate profitability to be privatised.

2.4. LATIN AMERICA: TRINIDAD AND TOBAGO – THE SMALL BUSINESS DEVELOPMENT COMPANY (SBDC)⁸

It is a guarantee programme, which started in 1990 with the establishment of a fund amounting to US\$5.2 mln. by the Ministry of Treasury. The SBDC is the implementing agency and has the control over the fund, which is invested in public bonds.

Between 1990 and 1995 the fund issued guarantees for 1855 loans for a total amount of US\$5 mln.; about 10 per cent of these loans were paid out in claims to participating lenders. At the end of 1995 the portfolio of guarantees amounted to about US\$3 mln.

Besides the revenues on the investment of the fund (an annual revenue of 12 per cent at the time of the analysis), the fund requires the borrowers to pay an annual guarantee premium of 2 per cent of the actual amount of the loan. Up to 1994, the premium comprised a front-end fee of 1 per cent of the guaranteed portion and an annual payment of 0.5 per cent of the outstanding guaranteed portion (some reduction were foreseen for loans from NGOs). It is stated that these revenues were sufficient to cover the fund's costs.

After some years of activity, the following remarks emerged:

- the selection of participating banks is important. The programme had originally envisaged a sort of automatic guarantee systems for loans granted by NGOs, implicitly assuming

⁸ For more details, see Allahar and Brown (1995). Also reported in Rabelotti and Viganò (1999).

that the NGOs were good enough to select their customers. As a matter of fact, NGOs had adopted a more "social welfare" approach in their evaluation and demonstrated an institutional weakness in their selection ability. This led to the interruption of this agreement. On the contrary, commercial banks proved to be good partners. After some years of activity, it was decided to adopt a portfolio guarantee system in the case of the two leading banks in order to eliminate the duplication of loan application analysis.

- The guarantee body and the participating banks must strongly co-operate. In Trinidad and Tobago, the professional staff of SBDC compensated the weakness of bank personnel in SME's loan evaluation. The former often organise training courses for bank staff.

- It is important that the guarantee body shows high credibility. Procedures must be clear and the agency should be ready to intervene as conditions are fulfilled, i.e. payments on claims must be prompt. Therefore, the implementing agency should have direct control on the fund, rather than transfer it to some governmental bodies, such as the Central Bank.

- Banks must be free to apply interest rates according to their internal policies and market levels. The experience of interest rate ceilings proved to imply disincentives for participating banks and ceilings were then removed.

- Lenders' transaction costs are usually high in this kind of projects as borrowers are high risk; in the case of Trinidad and Tobago, the intervention of SBDC in the preparation of the business plan and in monitoring repayment contributed to reducing the costs for the intermediary.

- All parties to the agreement must have a reasonable exposure to risk in order to reduce the problem of moral hazard; in the case under examination, this problem was stronger at the beginning and disappeared almost completely. Lenders' participation in the risk ranged from 5 to 50 per cent in face-value terms.

- The guarantee service should be accompanied by some other "developmental" services, like information, training, technical assistance, which contribute to better managing defaults and strengthening relationships with customers.

- These complementary activities should become the main activity of a guarantee programme as decisional powers and responsibilities for lending must gradually be transferred to the participating banks, thus reducing the guarantee intervention of the fund.

2.5. AFRICA: SENEGAL - THE GUARANTEE FUND OF THE PRIMOCA PROJECT

In the early '90s a very important development project was implemented in the South of Senegal, in the Moyenne Casamance Region, upon Italian Government's funding. The PRIMOCA (Programme de Développement Rural Intégral de la Moyenne Casamance) covered many sectors and a wide typology of interventions among which roads and other physical infrastructures, agricultural production improvement and rural credit in the Department of the City of Sédhiou.

The credit component comprised the creation of rural banks in 8 different villages in the Department, and the promotion of rural lending by the existing Caisse Nationale de Crédit Agricole du Sénégal (CNCAS). The project financed the creation of a branch in Sédhiou and the establishment of a guarantee fund to encourage the bank to start operations in the Department⁹.

Like in the case of Poland mentioned in paragraph 2.2, instead of creating an *ad hoc* executing agency, the fund was

⁹ The co-ordinator of this research had direct experience on this project as she worked for the company charged by the Italian Ministry of Foreign Affairs to control the execution of the Project. Only basic information is presented here as details are confidential.

directly deposited at CNCAS, head office. The branch in Sédhiou operated according to the bank's ordinary evaluating standards and, once they had accepted the loan, the guarantee was put into operation. Loans were covered by 70 per cent by the fund; in some special cases, for loans related to some pilot component of the project, coverage was 100 per cent. This latter category of loans was quite peculiar, given their developmental nature and is not commented here. For ordinary loans with 70 per cent coverage, repayment rates in 1994 and 1995 were quite satisfactory (more than 90 per cent). This result depended on several factors, among which:

- the determination of the bank to expand its market in the region, while controlling the quality of loans;
- the will of the bank to show good performance to the Italian project, in order to justify the support received by the donor.

Comparing this project with Poland's case, the main observations are:

- like in the case of Poland, the fund is directly deposited at the bank and, hence, management costs and the number of staff involved are quite reduced;
- like in Poland, credit risk evaluation is delegated to professional bankers avoiding the risks mentioned in par. 1.2;
- contrary to the case of Poland, the fund is allocated to only one bank without any competition or performance incentives. This could imply the presence of moral hazard; however, the moral hazard effect was almost non-existent as the bank wanted to prove its ability to operate to the project, and was at that time actually concerned about efficiently expanding its market.

2.6. ASIA: MALAYSIA – THE CREDIT GUARANTEE CORPORATION

The following case study has been analysed by various

observers, particularly with respect to the impact of the scheme in terms of additionality. The data are taken from the paper written by Boocock and Shariff (1996) who conducted a direct evaluation of the scheme.

The Credit Guarantee Corporation of Malaysia (CGC) was established to provide credit guarantees to SMEs and micro-firms operating in several sectors, including agriculture and manufacturing. The schemes proposed by the Corporation are the following:

- The General Guarantee Scheme (GGS), operating during 1972-1981
- The Special Loan Scheme (SLS), operating during 1981-88
- The Principal Guarantee Scheme (PGS), operating during 1989-94
- The New Principal Guarantee Scheme, operating since 1994.
- Other minor schemes have also been offered since 1986.

The first two schemes have declined in importance and have been replaced by the PGS which has introduced support to larger firms, higher limits on credit facilities, an increase in coverage from 60 to 70 per cent and a decrease in the fee applied to customers (0.5 per cent applied on the amount covered by the guarantee instead of the whole amount of the loan, as it used to be in the past). The interest rate, which used to be low and fixed, has been raised to be more proportionate to the risk.

The PGS has been analysed and the following considerations have emerged:

- as to the relationship among borrowers, banks and CGC, the company has no direct relationship with potential customers. From the interviews the Authors have conducted, it has emerged that most customers did not know about the existence of CGC and learnt about it from their bank. There-

fore, it was important for the company to strengthen its links with the banks, sharing risks and rewards with them;

- however, as the Central Bank had established quotas which banks must comply with in their lending supported by CGC, and penalties were foreseen for non-compliance, strong relationships with banks have been hard to establish;

- the relationships with banks have risked to be compromised also by conflicts on claims for repayment;

- finance additionality has been tested by examining the data and interviewing borrowers as to their access to other sources of funds, and banks. The data were not very significant as with the quotas imposed by the Central Bank it was difficult to estimate the impact. With respect to borrowers' and banks' statements, it resulted that 63 per cent of loans made by banks with the support of CGC had to be considered as additional finance (the percentage reduced to less than 50 per cent if other sources of funds were also considered);

- economic additionality, i.e. the direct benefits of lending for the SMEs and for the economy as a whole were also estimated but it is probably more difficult to draw conclusions on this issue.

The importance of the CGC lending to SMEs declined in 1993 because of the presence of non-bank financial intermediaries in the market. Therefore, in 1994, CGC launched the new PGS where companies of larger size were included, the amount of credit covered as well as the percentage of coverage and the interest margin were increased while the commissions were left unchanged. The cost for the borrower and the lender was then levelled according to international standard so that decisions would have to be made upon market parameters of risk and return. Moreover, finance companies were also allowed to use the guarantee scheme.

The start of the new project gave impressive results. Part of this success depended on contingent factors and on the fact that, with the new scheme, banks were covering a large pro-

portion of the loan with the guarantee (contrary to the past when they required the guarantee only for the part of the loan that was not covered by other collateral). However, the quality of the bank-CGC relationship also improved, as expectations for the future of the CGC were high.

The main observations derived from this case are the following:

- the importance of mutual trust in the relationship between the guarantee company and the bank;
- the importance of laying down appropriate conditions for the intervention;
- in doing so, attention should be paid to the introduction of suitable economic incentives for the participating banks (interest rates, coverage) and potential borrowers;
- external measures, such as the quotas imposed by the Central Bank, meant to force a specific behaviour may not necessarily have the intended effects if the above-mentioned conditions are not there.