

Chapter 5

CONCLUSIONS, LESSONS LEARNT AND RECOMMENDATIONS

The first paragraph of this section provides some critical observations on, and complements to the main aspects of the case studies, based on the reflections of the Consultants ¹ and on further information collected in the field. The second paragraph gives some recommendations for future action.

5.1. SOME CONSIDERATION ON EACH COUNTRY STUDY

5.1.1. *Egypt: The Credit Guarantee Company*

From the above analysis, it appears that CGC plays an important role in the Egyptian economy by encouraging the financial institutions to lend to SMEs with its guarantee fund backing. One of the factors behind CGC's effective role is its nature as a private company and the consequent flexibility that has enabled it to apply different systems, policies, and procedures tailored to each programme. Another advantage is its decentralised structure. Moreover, its private nature has allowed the Company to limit public pressure. Another factor of success is the constant attention given to the SMEs sector:

¹ The following observations are based on the comments provided by the Consultants in their background reports and complemented by the co-ordinator.

the new partnership with NGOs in both HCPP and Micro projects reflects this continuous tuning.

However, the Company faces different difficulties in its operation, that may be explained considering (a) the general environment of the SMEs business, and (b) the specific factors that relate directly to the Company's operation mechanisms and policies.

Point (a) includes difficulties such as:

- the profitability of a guarantee fund involved in high-risk business, which does not encourage shareholders to increase their shares or new shareholders to step in,
- banks' reluctance to deal with small projects due to the high transaction costs and relatively high risk.

Point (b) refers to:

- the Company's high administrative costs that add a burden on the Company's expenses and jeopardise its sustainability, despite the quite positive financial results of recent years;
- the credibility of the Company that is highly linked to the application of simple and easy liquidation processes ensuring quick and fair action for both the Company and the banks.

It is worth noting that, according to the interviews held with banks, the slow process of liquidation and the relatively long time taken by the Company to decide on default cases are some of the reasons that contribute to banks' reluctance to deal with it. However, in this respect, the Company confirmed that this remark is very well taken and that the Company is revising the contract with the banks to ensure clearer levels of responsibilities and follow-up process, agreed between the two parties. The Company is also reconsidering the liquidation process in an attempt to streamline it and ensure quick response to banks' requests of liquidation.

Concerning the way banks view the Company, they declared that they consider CGC guarantee as an extra security, sometime encouraging them to accept some credit cases which they would not have considered without this guarantee (in this

sense, an additionality effect is taking place). However, it should be noted that the banks still ask the borrowers to provide some collateral even in the presence of the guarantee, where the guarantee is considered as a second-tier security to share the risk and reduce the banks' risk ratio.

In order to increase the attractiveness of the system, banks stressed the importance of having high coverage by the Fund (80 to 100 per cent). This was introduced in the HCPP project where, despite high coverage, moral hazard phenomena are quite limited. It seems that this fact is due to the prevalence among borrowers of professionals who are highly educated, have a profession in which it is worthwhile to invest and are, probably, most keen to repay on time.

On the borrowers' side, the interviews with some of them revealed that only few even among those who benefit from the guarantee are aware of the existence of CGC. In this respect, banks explained that in some cases they add the Company's commission to the interest rate without even informing the borrowers; the latter, usually, do not ask nor bother, due to their poor understanding of banking operations and their relief at getting the loans against a limited collateral.

A direct question was asked to the borrowers aware of the guarantee system about their perception of the role of CGC and their willingness to pay an additional 1 per cent as guarantee fee. They evaluated it as a useful tool that provides them with access to credit with limited collateral and estimated that 1 per cent was a very small percentage representing no burden on their repayment.

As far as the agricultural sector is concerned, CGC stated that they might have a role in guaranteeing loans exceeding LE5,000 ² if a specific fund was allocated for these loans. CGC

² Banks declare that loans under this amount are not worth granting for them.

might also encourage the involvement of commercial banks if a guarantee percentage of over 80 per cent was offered.

As to CGC requirements, the limits of small agricultural loans emerge: besides the relatively higher estimated risk, their small size discourages the banks and CGC from intervening. In this respect, some observers are suggesting to consider a potential partnership between the company and viable NGOs or Agricultural Co-operatives to play the role of intermediaries, after enhancing their institutional capacity. However, the attempts that many development banks made in the past to work with rural groups or co-operatives as loans distributors were not always successful; they should not forget that great attention should be paid to the institutional viability of these potential intermediaries and that roles and responsibilities in disbursement and repayment should be clearly established³.

For Egypt's case study, it is worth mentioning that the new experience of the SFD — Guarantee Scheme, where beneficiaries become members of the scheme, may represent an interesting complementary action in the Egyptian financial market.

5.1.2. *Jordan: The Jordan Loan Guarantee Corporation*

The structure of the Corporation, where the Central Bank covers almost 50 per cent of total shares, has been one of the major factors affecting its positive performance. On one side, the capital is made available at no cost to the Fund and, on the other side, the Central Bank's important participation enhances the Fund's credibility and encourages other banks to join it. Through the expansion of its activities, JLGC has succeeded in achieving a high growth rate that has enabled the Corporation to cover almost 74 per cent of its

³ See Viganò (1992²)

administrative cost deriving from the guarantee on loans in 1998 and 53 per cent of total administrative costs in 1999, through the guarantee revenue.

The Corporation has been able to tackle different areas of activities and different target groups and respond to the different demands and needs of the country. The establishment of the export credit and counselling units are examples of this responsive approach.

The role of JLGC is highly received by the banks as they state that the Corporation participates in reducing the risk of credit, which leads to a higher volume of loans and a higher number of customers. This clearly emerges from the growing guarantee ceiling allocated to these banks by JLGC that rose from JD11 million at the end of 1997 to more than JD24 million in 1999. However, it should be noted that most participating commercial banks⁴ handle the JLGC guarantee as an additional security element besides the requested collateral. The guarantee provided by JLGC does not replace the missing collateral but it is in most cases added to the insufficient collateral, where the bank, in the presence of the guarantee, secures its loans by almost 150 per cent of the initial loan amount.

JLGC enjoys a high level of credibility among the commercial banks due to its effective system of guarantee and liquidation. According to the banks, the payment process of defaulted loans is quick and immediate, which is one of the very important factors encouraging banks to deal with the Corporation. The banks view the system of ceilings as a very good system that reduces the amount of necessary administrative work. The guarantee fee of 0.75 to 1.5 per cent is also considered to be reasonable.

The borrowers, on the other hand, appreciate the role of the JLGC that facilitates their access to loans, evaluate the

⁴ Based on interviews with both the Arab Bank and the Housing Bank in Amman.

incidence of the commissions as fair and consider the guarantee fund as a cheap tool to have access to credit.

Including agricultural activities in the Corporation's scope needs further examination, as the Corporation is relatively new to the market, and is still in the process of identifying secure areas of operation for expansion. The Corporation default ratio was reasonable as it reached 3.2 per cent by 1998 and is still within the limits of acceptability in 1999 (4.2 per cent). According to JLGC, getting involved in agricultural lending with its high default ratio of almost 10 per cent could jeopardise the current reasonable default status of the Corporation.

Also in this case, the Corporation could be encouraged to cover agricultural activities by establishing a special fund, especially if the measure is coupled with high coverage of the banks' risk. However, these measures may prove to be just a palliative solution if major steps are not taken to get the Corporation closer to the rural sector, i.e. getting it to know the agricultural credit business better, rather than just trying to cover its perceived risk. Contacts might be encouraged between JLGC and ACC.

5.1.3. *Morocco: Various Funds*

The situation in Morocco is quite peculiar. More than one Fund is operating, especially in favour of SMEs. The CCG is the largest Company, offering services to all types of sector on its own behalf or on behalf of other donors. Various reforms of the institution have taken place also as a consequence of the dissatisfaction of operators with CCG monopoly position and its long and heavy procedures for interventions. CCG was accused of being too strict in detecting imperfections in the documentation in order to slow down its interventions. These problems should have been overcome by the reform of 1996.

Dar Ad Damane has been created also as a reaction to

CCG monopoly. The other Fund, GPBM, has a different origin connected to a European Union intervention. Little information is available on the efficiency and effectiveness of these two funds. What emerges clearly from the analysis, however, is that none of the Funds in Morocco is really servicing the agricultural sector, with the exception of the Fonds des Calamités Naturelles.

The reasons are various, and among them, the prevailing administrative nature of CNCA. The latter, before becoming a bank, had experienced an abundance of funds made available by the Government; as a consequence, CNCA personnel became quite relaxed in loan analysis and evaluation and, in doing this, CNCA was satisfied with minor guarantees. Therefore, at that time, guarantees were not a problem. Financial constraints for CNCA have emerged later.

This minor role of guarantee funds in agriculture is also related to a major issue concerning the real need for an agricultural credit guarantee system in Morocco. Some observers are questioning the importance of guarantee funds because they estimate that the main problems of defaults in agricultural credit arise from the risks of drought. In this respect, given the high and generalised risk caused by this atmospheric phenomenon, a guarantee mechanism actually takes on the role of an insurer. In fact, the fourth guarantee mechanism of Morocco, the Fonds des Calamités Naturelles is acting as an emergency mechanism to protect the banks' portfolios ⁵.

The rationale behind all this, which will be recalled also in the case of Tunisia, relates to the role of credit, in a more general sense. Credit guarantee mechanisms may become a good tool to promote access to financial services only for those potential borrowers that have interesting investment opportunities and are only experiencing difficulties in getting in touch with banks. If the profitable investment opportunities

⁵ In this context, the idea of the insurance was introduced.

are minimal, as when the risk of drought increases, the real question is whether credit is still a valuable method of promotion or whether other measures, maybe of a fiscal nature, should be taken.

These considerations may lead to a complete exclusion of the agricultural sector from the credit market or at least from traditional institutional credit. In fact, some micro-finance institutions in the form of NGOs are starting their operations also in favour of rural borrowers. Among them, there are the Fondation Banque Populaire pour la Création d'Entreprises (People's Bank Foundation for Enterprise Creation) and the NGO Zakoura. However, the question of the role of micro-finance in development has already occupied the international arena and conclusions are not unanimous. While the role of micro-finance in softening the financial constraints of micro-units with reference to their subsistence problems is recognised, its contribution to enterprise development, especially for SMEs, is still questioned.

5.1.4. *Tunisia: the Fonds National de Garantie*

The National Guarantee Fund is consistent with the incentives to private investments offered by the Public Administration with an interesting division of functions among the Government, the banks and the insurance company. There is a high consensus on the usefulness of the National Guarantee Fund and all parties (Government, banks, economic agents) are trying to improve the system. However, as stated by the different actors, the Fund:

- is not characterised by additionality (this opinion is shared by all interviewees) ⁶;

⁶ As reported in the text, total loans covered by the Fund since 1993 accounts for 65 per cent of the loans outstanding at BNA at the end of 1998.

- it neither reduces the cost of credit nor does it speed up the evaluation process;
- it is not a collateral substitute, as banks still require traditional guarantees.

Therefore, according to the international standards mentioned in the first part of the report, the Fund cannot be judged as successful. Moreover, procedures are not smooth and banks sometimes declare that the waiting time for obtaining the refund from the Fund is long. The Ministry of Finance states that the announced reform addresses this problem.

The image of the Fund as perceived by the Tunisian banks has changed over time. In the past, before 1993, banks did not really consider the Fund as safe and durable. Therefore, even when they applied for the coverage, they did not keep track of it; in fact, now the Fund has some old portfolios for which it has no data. Only after the reform and the intervention of TUNIS-RE, has the attitude changed. After this change, the Fund appears now to be self-sustainable in the short-term even if perspectives are less clear in the medium/long term: the system of payment of the interest charges on loans to farmers hit by drought has some drawbacks as re-scheduling makes it harder for the borrower to repay the following years (two instalments at a time), which has led to foresee the intervention of the fund over five years. This may create some tension on the banks too. It is a crucial aspect as the long-term perspectives of the Fund are important when it comes to attracting banks.

The relationships between the Fund and the banks are not straightforward as some bankers and other operators perceive its role as more related to keeping the insolvent borrowers (because of droughts) in the market by helping them soften their financial burden, than to opening and widening the banks' markets. In this sense, the guarantee fund is not a collateral substitute as, if the banks are really concerned with

repayment, they will in no case accept bad-risk customers and will consider the guarantee as only subsidiary.

In fact, from the interviews and the observation of reality, it appears that the real objective of the National Guarantee Fund is not to expand access to credit by the marginal sectors of the economy, such as small rural producers, but rather to support small customers that are already indebted with a bank in case they run into difficulties due to contingent problems, such as a drought. This is probably a realistic interpretation that takes into account the apparently obvious observation mentioned earlier in the case of Morocco: credit is a useful tool for development only if opportunities of investment exist whereas it can be dangerous if the peasant is not in a position to invest the money in a profitable way. If this is the case, the Fund takes on the nature of an emergency fund.

On the side of the beneficiaries, particularly those hit by drought, they do not seem to really perceive the role of the Fund, as it primarily goes to the benefit of the intervening bank. Beneficiaries are mostly interested in having more flexible procedures in case of repayment difficulties. This perception is also likely to be a consequence of the fact that some of the beneficiaries are also receiving government support granted through BNA, which diminishes their fear of being rationed out. Another factor affecting the beneficiaries' perception is related to the fact that fees and commissions paid by the other categories of beneficiaries are mostly used for the cereal growers.

In summary, as in the case of the Fonds des Calamités Naturelles of Morocco, the Guarantee Fund plays a peculiar role, including an emergency component, which goes beyond the real nature of guarantee funds.

5.2. LESSONS LEARNT AND RECOMMENDATIONS FOR FUTURE ACTION ⁷

What follows is the proposal for a review of the main issues raised in this report in respect of the advantages and limitations of guarantee funds, with specific reference to the agricultural sector. The experiences gathered in the four case studies are used to qualify some of the statements and to reinforce the recommendations.

5.2.1. *The agricultural sector and financial services: is there a role for guarantee funds?*

From the picture of farmers' access to financial services outlined in the previous paragraphs, it appears that the banking system is marginally involved in offering its services to rural market segments. In general, the specialised lending institutions have to some extent proved to be successful in reaching customers, particularly in the area of short-term and seasonal loans; their outreach is on average quite good due to their large number of branches. However, while they are often the only formal source of finance for farmers, the effectiveness of their operation is (or has been) sometimes challenged by default ratios ⁸. Defaults may derive from an actually excessive risk in agriculture but also from a potential mismatching between the conditions offered by these specialised institutions on their loans and the expectations of rural entrepreneurs. In fact, standardised loan contracts, as it is often the case with specialised public banks, may not fit the very differentiated nature of the financial demands of rural customers. The latter may be induced to accept these loans,

⁷ This paragraph was written by the Co-ordinator. Useful suggestions, of course, came from the Authors of the field reports.

⁸ See, for instance, Mustafa (1999).

as they are the only opportunity they have, although they do not meet their preferences, which may contribute to increase the default ratio ⁹.

From these observations it emerges:

— a need for liberalisation of the operations of public development institutions, which is taking place to a certain extent in the countries analysed;

— the importance of a diversification of the activities of agricultural banks so that they can be in a position to compete in the market;

— more generally, the need for a diversification of the sources of finance for rural entrepreneurs

On the second point, a certain increase in supply has been recently taking place, as new intermediaries are starting operations in rural areas, such as micro-finance institutions or projects and NGOs providing also financial services, as their main mission or together with other activities. Their impact is difficult to evaluate on a general basis as, also in this case, their good outreach should be balanced against the costs of these interventions and, again, against the quality of their loans. In both respects some problem may arise as NGOs or projects are often benefiting of public subsidies to meet their operating costs and the quality of loans is not always good (as it is the case with Egypt's SFD). These performances may contrast with those of spontaneous informal micro-finance intermediaries that are usually good in assuring their self-sustainability and loan quality control ¹⁰ but cannot entirely meet potential demand.

What emerges from this picture is that:

— A major improvement in the access to financial services in rural areas can be achieved if the whole financial system starts to be attracted by these market segments.

⁹ These considerations are better explained in Viganò (1998).

¹⁰ See, on these experiences, among others: Adams and Fitchett (1992).

Within this framework, the hypothesis is that

— *Credit guarantee schemes can have the role of encouraging the different types of banks, including agricultural specialised banks, in getting involved in this sector.*

This intervention would enable the borrowers to have more than one alternative and create a healthy lending environment.

As it was stated in the opening chapter of this report, opinions on the effectiveness of guarantee funds are not unanimous. This report has examined the experiences of four countries to see whether some elements could be found to prove their usefulness and to point out some major recommendations on their design and operations.

No single pattern can be developed for credit guarantee schemes, as different factors depending on the country, the sector and the institutional setting are involved in determining the components of this pattern. However, some basic and general points can be made on the above review that may help in reaching a better understanding of the obstacles and risks that accompany the operation of these systems.

5.2.2. The success of guarantee funds: quantitative impact

In the theoretical part of this report, it was stated that the success of a guarantee scheme should be first evaluated on the basis of the impact it has on the access of target people (farmers, in this case) to financial services. However, it was also stressed that the evaluation of additionality is not straightforward, even when all the relevant data are available. In fact, while one can assess the importance of the operations promoted by a guarantee fund, nobody can be completely sure of what would have happened without the guarantee system and, therefore, it is almost impossible to measure the quantitative impact of a Fund.

In the four case studies analysed here, another element of

uncertainty adds in this respect as the available data are somehow fragmented and only give an idea of the size of the fund. In the presence of limited quantitative data, qualitative information may help interpret the additionality effect. What emerges from the above report is that, in both the cases of Egypt and Jordan, banks consider the guarantee as a supplementary collateral but not as a collateral substitute, which somehow limits the impact of the guarantee mechanisms with respect to additionality. In Tunisia and Morocco, on the other hand, the impact of the guarantee funds for farmers cannot be evaluated, as coverage is almost automatic in case of drought.

In the case of Egypt, particularly, a significant quantitative effect appears if one considers leverage, as utilisation of the guarantee fund is growing steadily. However, this indicator stands mainly for the ability of the fund to "multiply" the initial contribution it received and, only to a lesser extent, reflects the impact of the fund on the beneficiaries.

In order to favour the additionality effect,

— prior to establishing a guarantee fund, the need arises to assess the potential *intervening banks' attitude towards the agricultural sector* and to identify *the real bottlenecks in their process of approaching the sector.*

This statement appears somehow trivial but has enormous implications. In fact, while banks tend to cover their perceived risk with collateral, the reason for their hesitation to lend to agriculture is usually not due to the lack of collateral but rather to the lack of information on the customers as in the agricultural sector more than in other sectors quantitative data on the activity of the borrower are not available. For instance, it was noticed during the different interviews conducted in the course of this research that there is little awareness of the changes and developments in the agricultural sector, especially among bankers and credit guarantee companies' staff, even in countries where the progresses of the agricultural sector are evident.

In this context:

— *the real role of the guarantee fund is not to complement the collateral that is missing but, rather to encourage banks to get to know a sector that could be a lower risk than they perceive.*

— *If the information gap is the major problem, once banks get to know this sector, they should no longer need the guarantee system. This is the real additionality effect that should be expected of a guarantee fund.*

5.2.3. *The success of guarantee funds: the effects on banks' behaviour*

The opportunity to approach a new sector should be perceived by banks as a way to expand their market and their business. Otherwise, if this expansion is perceived as an imposition to comply with in order to achieve some social objectives pursued by the Government, banks might be more subject to moral hazard phenomena. In fact:

– if the banks require the coverage of the guarantee fund for loans that they do not consider viable but for which, given the guarantee, they take no risk, or only a small share of it, they may not feel the pressure to focus on the loan granting process. They do not fear insolvency when the guarantee coverage reduces insolvency costs;

– furthermore, banks that are not interested in widening their market towards the target group may not care about the preservation of the relationship with those customers when repayment becomes difficult; therefore, they can relax in using the guarantee fund. On the contrary, if the bank is interested in the segment, it will display all means to keep that relationship alive, despite the existence of a guarantee fund.

In fact, a low claim ratio (i.e. around zero) might be the sign of a relative ineffectiveness of the guarantee fund as the fund might be too conservative and have a limited impact. However, a too high claim ratio (over 5 per cent) may be

the result of a relaxed policy and may jeopardise the fund economic viability ¹¹.

Therefore:

— it must be verified that *the guarantee fund operates in a context where banks are willing to build long-lasting relationships with new market segments*, as a part of their strategy.

— In this context, *the leverage, taken alone, is not a sufficient indicator of success* as an increase in the outreach must be coupled with an *improvement in the banks' knowledge and appreciation of the target sectors*.

— *This would reduce the impact of moral hazard phenomena, and favour the possibility that the fund displays a permanent effect.*

Moral hazard is reduced if the fund coverage is not 100 per cent as, in this latter case, the bank does not take any risk and is more likely not feeling involved in the operations. The case studies have showed that there is a wide range of possibilities varying from full coverage to coverage as low as 50 per cent. The best practices mentioned in the introductory chapter suggest that coverage should not be higher than 80 per cent in order to avoid moral hazard phenomena. In this respect, the willingness expressed by banks to be involved in the agricultural sector only if coverage of at least 80 per cent is offered, should be carefully evaluated, as it may hide some risk of relaxation in the banks' motivation. This might be the case with the request of a high coverage ratio expressed by banks in Egypt and Jordan for loans to the agricultural sector.

Concerning this crucial aspect:

— On one side, *great attention should be paid when establishing the percentage of coverage*. Although there is no specific rule applicable to all cases, the risk of a too high percentage should be avoided by balancing the will to attract banks with the interest in keeping the banks' motivation alive.

¹¹ See chapter 1.

— The percentage should vary *according to the responsibility taken by the bank in the loan-granting process and should not be uniform for all customers*

— On the other side, when establishing a guarantee fund, *the will of banks to participate in the programme should be tested, once again, in terms of their strategic expansion plans rather than of their reaction to the percent coverage.*

5.2.4. *The success of guarantee funds: economic and financial performance*

Another important information that complements any evaluation of the impact of guarantee funds concerns the funds' economic and financial equilibrium, i.e. any fund should be considered successful only if its quantitative impact is consistent with economic viability (i.e. revenues covering costs), financial equilibrium (i.e. inflows covering outflows) and the risk it bears (i.e. risk exposure should be proportionate to the amount of the fund) so that self-sustainability can be assured in the long run. With respect to profitability, despite the relatively high numbers of their personnel, Egypt's CGC and Jordan's JLGC prove to be on the right path in the period analysed (however, with the contribution of low cost funds). This matter is difficult to judge in the cases of Morocco and Tunisia where, with specific reference to the funds for the agricultural sector, given their purely public and emergency nature, the importance of self-sustainability has been underestimated. However, the solution of Tunisia to pass through an existing insurance company is quite interesting although it requires that roles and responsibilities are well defined.

Self-sustainability is easier to achieve if the fund is deposited at one or several banks rather than creating an *ad hoc* structure as this at least avoids a duplication of efforts and costs for loan analysis.

— *attention to economic and financial self-sustainability is higher in the funds with a private institutional structure, like a joint-stock company, even when the capital is publicly owned.*

— *in the case of public funds directly managed by some governmental authorities, it may become more difficult to focus on costs and revenues as management expenses are often borne by the public entities managing the funds with their own personnel and premises.*

In the latter case, a specific accountancy system should be developed in order to keep the performance of the Fund under control. This system, however, is sometimes probably deemed to be too costly as compared to the perceived advantages of such control, especially for public funds.

An important contribution to self-sustainability can derive from investing the fund in profitable assets. However, this should not reduce the incentives of the fund to issue the guarantees. In fact, it has been observed that an excessive stress on "making a profit" may induce the guarantee organisation to be too much concerned about preserving the fund in order to obtain an income from investment and, consequently, slow down the process of issuing guarantees¹².

As a matter of fact, guarantee funds seldom achieve economic and financial equilibrium and, in many cases, receive public subsidies. In this respect, some observations are made hereafter.

5.2.5. *The success of guarantee funds: the effects on the borrowers' behaviour*

With respect to the determinants of profitability, besides the opportunity to invest the funds in remunerated assets (which happens in most of the cases analysed), the role of the fees paid by the beneficiaries or by the banks should be

¹² See Levitsky (1997¹) who refers to a case in Romania.

stressed. In the cases under analysis, beneficiaries pay a commission and, when interviewed, declare their willingness to do so, considering the advantage of thus getting an easier access to bank loans.

The case of what could be called "emergency fund", such as in Tunisia, is quite peculiar. As explained earlier, the fund is designed to intervene in case of general atmospheric damages in order to reduce the impact of loan losses on the participating banks. In this case, beneficiaries seem to be quite inelastic to the application of fees because they are actually more concerned with not being sued for insolvency than with having better opportunities to get a loan.

On the beneficiaries' side, it could be concluded that

— *it is important that loan beneficiaries are aware of the advantages implied in the fund coverage so that they are willing to buy the service and pay a fee for it;*

— *for this purpose, however, the fund must offer a real advantage to the beneficiary, i.e., improved probability of access to financial services.*

There are actually some contra-indications to the application of fees to the beneficiaries, as they may increase the moral hazard affecting the bank-customer relationship. In fact:

— *if the beneficiary is aware of the guarantee coverage, she/he might be tempted not to repay; this temptation might even be stronger if she/he has paid a fee, because defaulting might be considered as a way to recover the fee expense.*

— *In this respect, co-operative guarantee funds, where the members are also the beneficiaries, might reduce this risk*

— *the image that banks transmit to their customers is also crucial in controlling this risk*

— *the reputation of the guarantee fund is important as well.*

Once again:

— *it is the basic willingness of the bank to establish long-lasting relationships with new market segments that can make the difference*

as in this case customers are more interested in being eligible to new loans than to exploit the advantage of the guarantee coverage for only once. For the same reason, the image of the guarantee fund is also important. Co-operative guarantee funds may find it easier to preserve their image as members have incentives to keep the funds' reputation and, therefore, to believe in it.

5.2.6. *Preconditions for success: the reputation of the fund and its effectiveness*

The aspect just mentioned above, i.e. the reputation of the guarantee fund, is important because it affects customers' behaviour in the sense that if the customers feel that a fund is stable and durable, they may be more encouraged to repay regularly in order to benefit again of the fund's coverage in the future. On a more general basis:

— *The reputation of the guarantee fund is important as a basic precondition for its overall success, with respect to its relationship with the borrowers, the banks, the financial market as a whole, and the public authorities.*

In fact, even taking the additionality and permanent effects of the guarantee funds for granted, the operational success of a guarantee system depends on its *effectiveness, sustainability* and *adaptability* to local conditions, which contribute all to making its reputation.

— *The effectiveness of a guarantee fund, with respect to banks and customers' expectations, depends very much on the quality of the services it provides in terms of decision-making processes, paperwork, monitoring and liquidation systems.*

It is crucial that clear rules are established among all the parties involved — the funds, the banks and the beneficiaries — without making the process too long or too heavy. In fact,

the relative burdensome procedures noticed at least in some of the cases analysed, where bureaucratic accomplishments prevail over the actual appreciation of risk, undermine the effectiveness of the funds. The need for a quickly responsive system of appraisal and liquidation has emerged, particularly from the concerned banks. This does not mean that the funds should relax their attention on the guaranteed loans but that clear relationships with the banks should be established, in which monitoring is performed effectively and, therefore, liquidation is speeded up. In this context, exclusion criteria for non-performing banks should be envisaged so that the funds keep the quality of their partners under continuous control and, therefore, can be more flexible with performing banks. On the contrary, delays affect the guarantee credibility and discourage banks from dealing with guarantee companies.

5.2.7. *Preconditions for success: the relationships between the fund and the participating banks*

The effectiveness of the Funds is pivotal in determining success, as ¹³:

— *the effectiveness of guarantee funds depends on, but also contributes to, building trust between the funds and the banks*

As shown in the case of Malaysia, examined in paragraph 2.6, mistrust between the fund and the banks may compromise good implementation of the Fund's operations. Trust is particularly important if the funds do not intervene in loan-granting decisions but delegate this responsibility to the bank. However, this is not often the case, as in most of the funds analysed the guarantee institution performs its own evaluation on the acceptability of the loan. There is actually a difference between

¹³ On this perspective, see Masini (1985)

the guarantee companies operating in all sectors and the programmes designed for atmospheric disaster in Tunisia and Morocco. In the latter cases, risk analysis may not be performed at all as, when a disaster occurs, the intervention of the fund is almost automatic; but this is a special case where the decision is made in compliance with public procedures rather than based on individual borrower's creditworthiness.

The activation of the fund's decision on each individual borrower derives from its direct involvement in the operation coverage. It has been observed that this double verification is quite costly but seems unavoidable unless the fund acts according to a portfolio model covering a certain share of the bank's portfolio and leaving the bank free to choose the beneficiaries. In any case, when the fund is not in direct contact with the borrowers, the role of the bank and its good and clear relationships with the fund become extremely important.

— One way of meeting the need to *avoid duplication of efforts* in loan analysis while *keeping the risk under control* is to *put the fund directly under the management of one or more banks*, giving them full responsibility for coverage decisions but also providing some mechanisms to *hold them responsible for the fund sound management*.

This is, for example, the case of Poland (par. 2.2) where the incentive to good performance is represented by the prospect for banks to transform this fund into capital after some years of sound management. This solution has the advantage of assuring speedy and flexible procedures, and reduces management and transaction costs. The same solution has been applied in the case of Senegal (par. 2.5), but the intervention of just one bank may reduce the incentive as compared to the case of a competitive environment.

The direct involvement of banks requires, once again and even more than in other solutions, that the banks feel really committed to expanding their market through these funds, and, of course, that they are sound financial intermediaries.

Especially if the funds are made available by the Governments, a risk should be avoided, i.e. that banks consider these funds as subsidies that they are allowed to use to provide services to some market segments that, although unattractive, are part of major Government priorities which these banks should comply with. This is why the banks' spontaneous willingness to expand the market should be apparent and their soundness proven.

The process of bank selection and the incentive system, therefore, are very important. The case of Trinidad and Tobago (par. 2.4) shows the importance of selecting performing banks and, on the contrary, the potential difficulties involved in operating with NGOs. Good performance may be encouraged by some incentive measures; for instance, in the Italian case, the banks' contribution to the fund is proportionate to their performance in loan recovery.

5.2.8. *A leading principle: the market view*

After all these reflections, an idea emerges as the leading basic principle of guarantee funds creation, besides any consideration on their impact or effectiveness:

— All major parties in a credit guarantee system need to share the objective of *favouring the access to sound, responsive, market-based financial services*, to the advantage of both the clients and the institutions that serve them.

— The goal should be to provide *rural entrepreneurs with access to credit*. In this view, subsidies are not a real issue and may create heavy distortions.

In this perspective, any measure to encourage the approach of rural customers to financial services should be taken as a means to promote the development of market forces by avoiding, or at least reducing, any distortion effect so that the mechanism may show its ability to become self sustaining and independent.

This market approach is likely to be more feasible in countries where the process of liberalisation of the economy is advanced while it is difficult to implement if the guarantee fund has to comply with, for instance, a heavily administered agricultural credit system.

In this market perspective, a guarantee fund might have the following characteristics:

- private beneficiaries or lending banks may take a part in the capital of the fund ¹⁴;

- the Government may act as a private shareholder without influencing the flow of resources and avoiding any compulsory link between the (agricultural) loan and the guarantee;

- borrowers pay the guarantee service they receive entirely.

In the reality of many countries, also those analysed in this report, Governments' or donors' support to credit guarantee funds is quite strong because guarantee funds are considered to be of public utility, as tools to promote private investment in general. This is one of the reasons why guarantee funds are often criticised, also in industrialised countries.

What should be kept in mind is that:

— *external subsidies change the comparative economic advantage of financial transactions* and, while they may promote some bankable customers' access to credit, they may also promote access to credit by sick firms, thus encouraging adverse selection, or encourage banks or customers to be negligent in their operations, as explained earlier.

It is quite dangerous to entrust guarantee funds with solving the problem of access to credit for the customers that are not creditworthy, even if the latter deserve attention from a social point of view. As a matter of fact, and according to this view:

¹⁴ As already stated, this institutional measure may limit the moral hazard on both the borrowers' and the banks' side.

— *credit guarantee mechanisms may become a good tool to promote access to financial services only for the potential borrowers that, having attractive investment opportunities, are experiencing some difficulties in getting in touch with banks*

This may appear to be a quite restrictive view, limiting the scope of guarantee funds. However, it should be considered that:

- if potential borrowers do not have attractive investment opportunities, it becomes hard for them to repay their loans;
- attractive investment opportunities are not a matter of size and may also exist for small or micro entrepreneurs.

In fact, in many developing countries, nowadays more than in the past, commercial banks are looking with some interest at rural markets, as it seems that profitable opportunities exist also in rural areas, even on small rural loans. The main problem is that these banks do not have sufficient expertise in dealing with these customer segments and, therefore, are discouraged from starting operations.

Of course, is not easy to start working with these new market segments, as it requires developing specific competencies, particularly when firms are small, somehow informal and very different from those banks are used to deal with in the trade or manufacturing industries. Appropriate products, lending technology, evaluation processes and procedures, marketing techniques, delivery mechanisms, monitoring, and pricing systems should be developed and are the most important conditions for the success of their expansion in operation ¹⁵.

— *Guarantee funds may be considered as supportive measures that, in this context, would encourage banks to develop their own ability to establish relationships with new customers.*

¹⁵ Gudger (1998) and Viganò (1992¹).

— Some *improvements* may also take place *on the borrowers' side* (upgrading).

Concerning the latter point, for instance, a major step in making the rural sector more attractive is educating rural entrepreneurs to deal with banks, to submit clear and documented applications and to negotiate with banks. In one of the guarantee systems studied in this report, the case of Jordan, a supportive service in this respect is offered as the fund has a consultative department assisting borrowers in their relationships with banks. Other external entities, such as NGOs, can also play this consultative role. The potential role of NGOs is better analysed in the following paragraph.

While these encouraging measures are meant to stimulate a spontaneous action by banks, it is not advisable to push banks to intervene by imposing mechanisms such as the compulsory quotas established by the Central Bank in the case of Malaysia. These mechanisms do not prove to be very effective.

5.2.9. *A leading principle: credit, development and the role of the Government or extension services*

It may be objected that the market view presented above is hard to achieve, as rural operators are so poor or so high risk that no bank would ever intervene without some guarantee or other encouraging measure. This may in fact be the case in some countries as it happens, for instance, with farmers-cereal growers in Morocco and Tunisia in periods of serious droughts. However, in such situations, it is hard to imagine that any credit intervention would ever be a success; in fact, in the Moroccan and Tunisian cases, it is declared that these funds have the nature of an emergency intervention rather than of a guarantee.

When this is the case, the Government should have the role to promote conditions for farmers to become bankable

through public interventions such as building infrastructures (e.g. irrigation or transportation systems), liberalising commodities markets, introducing land tenure regulation, improving the legal environment or farmers' education to financial culture.

These are measures of a fiscal nature that should not be implemented through the banking system. They may complement the action of the banking system or be implemented prior to any credit intervention. Contrary to what happened in many developing countries in the past decades, it should be recognised that:

— *Credit is a supporting development instrument when some development pre-conditions are there, as it can leverage the expansion potential of local entrepreneurship.*

— *However, credit alone cannot solve the problem of poverty or the promotion of the private sector if these pre-conditions are not there.*

Some observers are looking at NGOs, Agricultural Co-operatives, and extension agents as actors that can help create the pre-conditions for making credit intervention feasible. Of course, being close to the rural sector, these entities may be a valuable support in improving farmers' professionalism by transferring technical knowledge, organisation and marketing skills and by promoting access to basic infrastructures.

On the contrary, they can hardly be viewed as potential intermediaries between banks and rural customers. For instance, in the past, many development banks passed through extension agents or co-operatives for credit delivery to rural customers but, on average, those experiences have been deceiving. The co-operative or the external agent being just a "fund disbursing unit", they hardly felt really involved in the loan evaluation process, follow-up and recovery and their "false integration" in the banking structure often ended-up in many defaults¹⁶. Unless intermediate structures are en-

¹⁶ See, on this subject, Masini (1987 and 1989).

trusted with specific responsibilities, they may not be effective and can have serious drawbacks.

For the same reasons, when talking about guarantee funds:

Intermediate structures, like NGOs or co-operatives, may well offer some supporting services, like education services, but it may not be suitable to include them in the credit delivery mechanism or the guarantee assessment process.

The case of Trinidad and Tobago is a good example of the dangers of integrating NGOs in the lending process, unless these entities are really specialised in banking activities ¹⁷.

5.2.10. *Are there market alternatives to guarantee funds?*

While it might be dangerous to implement a forced integration of the supportive organisations mentioned in the previous paragraph in the financial service delivery process, the success that some spontaneous group, pre/co-operative or in the form of NGOs or other *micro-finance intermediaries* are having in providing financial services to the rural sector is an altogether different matter. These experiences are well developed, for instance, in most African Sub-Saharan countries, and many of them have their roots in traditional cultural values that led to their establishment decades or even centuries ago. Some observers view these structures as valuable alternatives to the banking system in offering financial services to rural areas, thus also reducing the needs for guarantee mechanisms. As mentioned earlier, some experiences are taking place also in the countries analysed, such as in Tunisia or Egypt.

¹⁷ The opportunities and limits of NGOs in this context depend on the nature of the NGO. While some of them may be considered as real banks, as they have developed banking skills, some others are not specialised in this function. In the latter case, their integration in the lending process is dangerous. On the subject, see, for instance, Adams (1998) and Mustafa (1999).

While the role of these intermediaries, which may also be informal or semi-formal, is universally recognised, particularly for the lowest-income bracket of the population, given the small amounts of their transactions and the prevailing short-term nature of their lending, their effectiveness in promoting rural entrepreneurship going beyond subsistence farming is still an open question. Therefore, they might be better viewed as complementary to, rather than substitutes for banks intervention.

As a matter of fact, besides the important issue of encouraging banks to adopt an *appropriate lending technology* for the target customers, which may help treating the information and control for the risk of default ¹⁸,

Some alternatives to guarantee funds exist with the same goal of encouraging banks to deal with rural customers, among which group lending practices, the request for a borrower's personal contribution or, simply, the application of a higher interest rate, proportionate to the higher risk.

An appealing possibility to promote direct relationship between banks and rural customers without the intervention of guarantee funds is represented by *group lending*: farmers' associations or groups apply for a single loan to a bank and, instead of a collateral, offer their joint responsibility. If in the group there is strong cohesion among members, this system may work very well, as peer-monitoring among members and the members' will to keep the reputation of the group are much more effective than any collateral measure. Again, some interesting experiences can be found, for instance, in Africa. On the other hand, group lending becomes risky when the group link is loose. In group lending, then, the real challenge for the bank is assessing the nature of the group; if the loan amount is important, the bank may find it

¹⁸ See, for instance, the applicability of credit scoring techniques, as suggested in Viganò (1993).

reasonable to invest its time in this evaluation, which is not the case with single borrowers.

Another alternative to guarantee mechanisms is the practice to ask the farmer to deposit a percentage of the amount of the loan she/he is applying for with the bank as a *personal contribution*; this deposit may be remunerated or not, and is used by the bank to partly cover the loan in case of insolvency. The final effect of this measure is that:

- instead of paying a fee for the guarantee, the borrower has an implicit cost derived from renouncing to use the deposited amount (in particular, if this deposit is not remunerated) and an explicit cost for the interest she/he has to pay on the supplementary amount she/he has to borrow from the bank;

- in case of default, the bank is covered by the percentage of the deposited amount. The coverage is usually much lower than the average percent coverage assured by guarantee funds.

Another alternative, suggested by the observers who are sceptical about guarantee funds, is that banks may just *increase the interest rates on loans* of a percentage corresponding to the higher risk¹⁹. In comparison with a guarantee fund operating according to market rules and without subsidisation, the average increase in the interest rate would be as high as the fee that the guarantee funds demand of their customers. While this alternative has the advantage of eliminating the risk of moral hazard, the hypothesis of equivalence of the risk premium is not straightforward. In fact:

— While an individual institution may not be able to diversify its portfolio risk, *the guarantee fund*, especially if operating with a substantial number of banks, *can have some advantage in risk diversification*.

¹⁹ In this sense, for instance, a comment by Richard Meyer appeared on the electronic "Development Finance List" of The Ohio State University (26 May 1999).

— Guarantee funds may become *information poolers*, concerning both individual borrowers status and standard behavioural patterns which may give them a comparative advantage in the *information processing*, with specific reference to *risk assessment and control*.

— Through appropriate incentives to assure the quality of the information, its reliability and the process of delivery, they can make the use of this *information effective for the benefit of all the parties involved*.

— Another advantage offered by the access to a guarantee fund is a *reduction in the bank capital requirement*, considering that the bank is taking a limited risk.

Some alternative ways of diversifying the risk of agricultural loan portfolios have recently emerged. For instance, it is possible to think of applying *credit derivatives* also in this context and thus transferring some of the portfolio risk to other banks²⁰. However, these techniques are still at an early stage in many countries.

Among the alternatives discussed above, some (such as group lending) can be relatively easy to apply while others (like the use of credit derivatives) require the existence of well-developed financial markets.

In conclusion, despite the many possible limitations and drawbacks that have been pointed out, also with reference to the experiences examined in this report, guarantee funds may actually play a role.

5.2.11. *A final statement on the potentialities and limits of guarantee funds*

If, as it was stated above, the major obstacle to bank lending is not the objective risk of the agricultural sector but, rather, the risk that banks perceive due to their lack of knowledge of the agricultural sector,

²⁰ Masini (1998).

— By increasing the threshold of acceptable risk to the bank, *guarantee funds* may effectively be the *starting phase of a "customer knowledge" learning process*;

— by pooling the data on several customers with different behavioural patterns, they may become a precious *source of information* for the financing institutions;

— to a certain extent, *they also decrease the transaction costs*, if they speed up the evaluation process ²¹.

Their effects are more likely to be beneficial if these structures operate according to the usual good management principles of any financial intermediary, i.e.:

— they adopt a suitable organisation structure, which should not necessarily be big or complex;

— they adopt flexible procedures and adjust to different contexts (decentralisation might be important in this respect);

— they balance the need for a suitable structure with the need to keep their expenses under control and to pursue the goal of self-sustainability (for instance, the goal of decentralisation should be made consistent with the costs of such a policy);

— they have good quality and motivated personnel.

All this would contribute to promoting long-lasting effects on bank-customer relationships. Of course, once again:

— What stated above presupposes a *real interest on the part of banks to work with the target beneficiaries*.

— *If this is not the case*, as banks feel that the target sector is not profitable and they are not interested in it, *guarantee funds may have a very limited impact*.

— The case of *the agricultural sector may fall in with the first or the second case depending on the countries or productive areas*.

²¹ This effect is the opposite of what stated by some observers of guarantee funds because they find that the burdensome procedures and the double screening by the bank and the fund usually increase the cost (see chapter 1).

The opportunity to launch guarantee schemes for the agricultural sector depends on this basic distinction. Once it is estimated that banks have a real interest in the sector, because it offers some appealing investment opportunities, then, the suggestions presented in this report can be taken into consideration for the implementation phase. In the opposite case, i.e. if the agricultural sector is actually too risky and low profit, some fiscal measures are necessary and no guarantee fund could solve this structural problem.

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IN THE VARIOUS COUNTRIES: Interviews with anonymous guarantee funds beneficiaries.

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RURAL CREDIT
GUARANTEE FUNDS

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EDITORE

Summary

NENARACA (Near East-North Africa Regional Agricultural Credit Association), in cooperation with FAO, and CICA (Confédération Internationale du Crédit Agricole) carried out a study on the applicability, advantages and limits of guarantee funds with specific reference to agricultural credit in the Near East and Northern Africa Region. The research was financed by CICA. The Co-ordinator of the research team and author of the study is an advisor of Giordano Dell'Amore Foundation. The study covers the following aspects:

- a review of the literature on guarantee funds and best practices for their application;
- some international experiences;
- the analysis of guarantee funds in four countries of the NENA Region: Egypt, Jordan, Morocco and Tunisia.

The main aspects covered for each guarantee scheme are: history, legal status, funding, working principles and procedures, quantitative data and financial performance, contribution to the agricultural sector, perspectives.

Based on these experiences, some key issues for the implementation of a sound and effective guarantee system are presented. It emerges that guarantee funds:

- have the main function of reducing the information gap between the customer and the bank, so that direct relationships between the two parties may later take place;
- can be effective only if banks are willing to establish long-lasting relationships with previously ignored market segments;
- are not the sole measure to encourage bank lending and, in any case, cannot solve the structural problems the agricultural sector might suffer which often prevent sound financing practices.

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