How to do

Loan Guarantee Funds

Investing in rural people

Inclusive rural financial services

How To Do Notes are prepared by the IFAD **Policy and Technical Advisory Division** and provide practical suggestions and guidelines to country programme managers, project design teams and implementing partners to help them design and implement programmes and projects.

They present technical and practical aspects of specific approaches, methodologies, models and project components that have been tested and can be recommended for implementation and scaling up. The notes include best practices and case studies that can be used as models in their particular thematic areas.

How To Do Notes provide tools for project design and implementation based on best practices collected at the field level. They guide teams on how to implement specific recommendations of IFAD's operational policies, standard project requirements and financing tools.

The **How To Do Notes** are "living" documents and will be updated periodically based on new experiences and feedback. If you have any comments or suggestions, please contact the originators.

Originators

Michael Hamp
Lead Technical Specialist, Inclusive Rural Financial Services
Policy and Technical Advisory Division
E-mail: m.hamp@ifad.org

Francesco Rispoli
Senior Technical Specialist, Inclusive Rural Financial Services
Policy and Technical Advisory Division
E-mail: f.rispoli@ifad.org

Jonathan Agwe
Senior Technical Specialist, Inclusive Rural Financial Services
Policy and Technical Advisory Division
E-mail: j.agwe@ifad.org

Acknowledgements

The writing of this toolkit has been a highly collaborative effort and we the originators would like to thank Miriam Cherogony, Emily Coleman, Chris Jarzombek and Graham Perret for their support and contributions. We thank our peer reviewers of the Policy and Technical Advisory Division of IFAD for their insightful feedback.

Contact

Maria-Elena Mangiafico
Knowledge Management and Grants Officer
Policy and Technical Advisory Division
E-mail: m.mangiafico@ifad.org

October 2014

Table of contents

List of acronyms

ACGSF	Agricultural Credit Guarantee Scheme Fund
AGRA	Alliance for a Green Revolution in Africa
CGAP	Consultative Group to Assist the Poor
CGS	credit guarantee scheme
FSP	financial service provider
LGF	loan guarantee fund
MFI	microfinance institution
MIS	management information system
MSMEs	micro, small and medium-sized enterprises
PDT	project design team
SMEs	small and medium-sized enterprises
USAID	United States Agency for International Development

Introduction

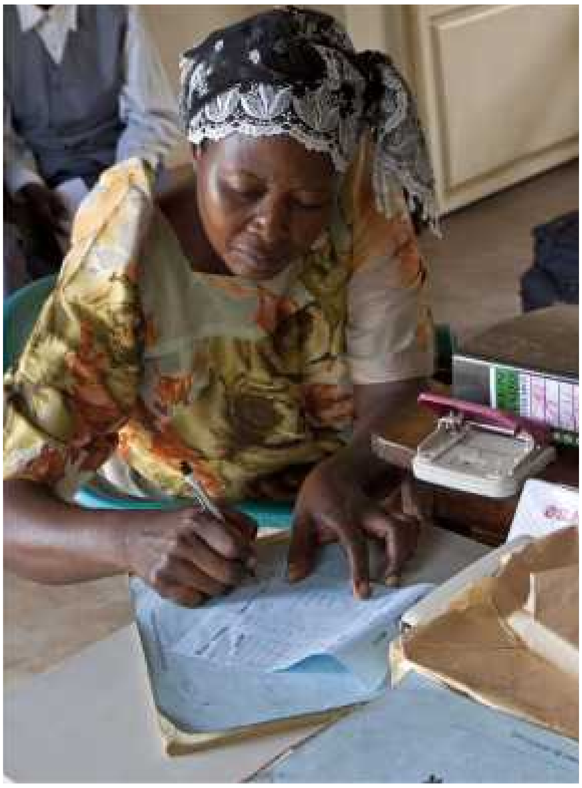
For over seven decades, loan guarantee funds (LGFs) have been used extensively with varying measures of success. There has been a recent surge of interest in this instrument, in particular with a view to increasing the financial access of low-income microentrepreneurs such as farmers.

This How To Do Note highlights the rationale for using LGFs, focusing on different types of guarantee arrangements, as well as their strengths, weaknesses and opportunities. It also summarizes global experience with LGFs. The output is based on consultation and desk study guided by IFAD's *Rural Finance Policy* (2009) and the *Decision Tools for Rural Finance* (2010).

The How To Do Note provides country programme management teams (CPMTs), programme design teams (PDTs), implementation teams, and other practitioners and users with evidence-based good practices and guidelines so that they can design and implement more effective and contextually appropriate guarantees. However, it does not provide all the answers, nor does it provide models that can be simply replicated from one context to another.

What are loan guarantee funds (LGFs)?

LGFs are non-bank financial instruments[1] aimed at facilitating the access of micro, small and medium-sized enterprises (MSMEs) to formal lending through the provision of credit guarantees that mitigate the risk of non-repayment. In practice, LGFs replace – or at least reduce the need for – other forms of guarantees and, therefore, make it possible for a larger number of MSMEs to access new loans or obtain larger loans. Although established to alleviate risks of commercial, formal financial institutions, in order to avoid problems with "moral hazard" and opportunistic behaviour, LGFs do not cover the full value of loans. Normally, credit guarantees provided by LGFs only cover between 50 and 70 per cent of the value of loans (but variations observed internationally for partial guarantees were between 30 and 80 per cent of the principal loan amount outstanding). The guarantee schemes are licensed and supervised by central banks or other financial sector regulators and they are subject to minimum capital requirements.



IFAD/Radhika Chalasani
Uganda - UWESO Development Project

Essentially, an LGF is a commitment by a third party to cover all or some of the risks associated

[1] LGFs are usually non-bank financial instruments but, in some countries, they are institutionalized as guarantee banks.

with a loan to its client,[2] who does not have sufficient bank worthy collateral. The LGF removes barriers to financing for the borrower and permits financing on more favourable terms. LGFs can be used for MSMEs that are commercially viable but face additional barriers to financing. It aims to catalyse rural finance by improving private sector lending terms, such as reduced interest rates, reduced collateral requirements and/or increased loan tenors by lenders.

Guarantees are usually issued against the payment of a guarantee fee, aimed to remunerate the risk taken by the scheme. They have been widely advocated by development finance professionals to address difficulties faced by individuals, households, farms and other small firms that wish to borrow from formal financial institutions. MSMEs face credit rationing by formal sector lenders; when they do obtain such credit, it is often on comparatively disadvantageous terms. LGFs supported by donor or government subsidies have been recommended as a means of addressing these difficulties.

What justifies the use of LGFs?

Formal financial institutions are typically disinterested in servicing IFAD-type target groups for many reasons, including: (i) a lack of economies of scale; (ii) high transaction costs; (iii) a perception that rural poor are not creditworthy; (iv) the uncertainties in small and medium-sized enterprise (SMEs); (v) the high failure rate of MSMEs; (vi) the vulnerability of MSMEs and the rural poor to market and economic changes; (vii) the reluctance of MSMEs to borrow from formal financial institutions; (viii) the high administrative costs of lending to MSMEs, which reduce the profitability of loans; and (ix) the inability or unwillingness of MSMEs to provide accounting records and other documentation and collaterals required by formal financial institutions. As a result, access to credit is greatly constrained for MSMEs.

LGFs can overcome these constraints, offset or minimize the risks of lending to the rural poor and MSMEs, and compensate for low profits, making them more attractive to the formal sector.

The expectation is that the LGFs will: (i) unlock access to finance at scale for agriculture; (ii) create a syndicated risk sharing facility to foster competition among banks and lower interest rates for farmers and MSMEs; (iii) lower the risks faced by formal financial institutions; (iv) decrease transaction costs of formal financial institutions lending to agriculture; (v) develop a technical assistance strategy to allow efficient agricultural lending; and (vii) build social impact mechanisms to measure effectiveness of lending to agriculture.

There are two basic LGF models: an LGF as a specialized company with a separate legal entity and an LGF with a multi-purpose set-up. In the former, a company manages an LGF, while in the latter, a guarantee fund is aligned to an existing organization’s other activities. According to recent experience, specialized single-purpose entities, e.g. The Credit Guarantee Trust for Micro and Small Enterprises (http://www.cgtmse.in/) in India and the Agricultural Credit Guarantee Scheme Fund (ACGSF) in Nigeria, are preferred to “multi-purpose” models.

LGFs can be registered as private companies or non-profit organizations, depending on shareholding arrangements. IFAD’s *Rural Finance Policy* and the *Decision Tools for Rural Finance* identify four shareholder profile categories: (i) public sector agencies at the central, regional or local level of government; (ii) private entrepreneurs (individuals or consortia); (iii) financial institutions (e.g. banks, insurance agencies); and (iv) other non-private actors from civil societies (foundations, NGOs, etc.).

[2] In legal terms, a guarantee is an "an obligation undertaken by a party (guarantor) to satisfy the payment of a debt or the fulfilment of a contractual obligation on behalf of another party (the debtor) toward a third party (the beneficiary) if and when the debtor fails to pay or comply with the terms of the contract”.

From the few successful LGFs – including the DCA[3] – the corporate governance and ownership profile largely determines the success of LGFs due to specialized companies, with specialized staff executives from the private sector given preference.

What guarantees can do	What guarantees cannot do
▪ Provide additional collateral to otherwise creditworthy borrowers who have insufficient collateral. ▪ Give banks an opportunity to practise lending to a new type of customer – farmers, SMEs and exporters, etc. ▪ Act as a catalyst – encouraging further lending after guarantee expires. ▪ Leverage scarce public resources (programme capital) by unlocking private capital.	▪ Improve a borrowers' capacity to repay a loan (i.e. make a fundamentally uncreditworthy borrower creditworthy). ▪ Provide an excuse for banks to perform poor credit analysis or avoid an aggressive pursuit of repayment. ▪ Automatically make banks better at assessing and managing credit risk. ▪ Compensate for a lack of liquidity or a maturity mismatch (funding long-term loans with short-term funds).

Context and IFAD's perspective on LGFs

IFAD's practical experience with LGFs is limited. IFADs Rural Finance Policy framework of 2009 provides clear overall guidance for IFAD operations

> *Credit guarantees can support pro-poor financial transactions under certain conditions by offering the partial coverage of lending risks. Credit guarantees are only effective when fully integrated into the existing financial market and managed by finance professionals who know the market well. Governments or publicly-owned special-purpose vehicles for risk management have had very limited success in effectively managing guarantees. Furthermore, the full costs of guarantees to the financial intermediary and the client need to be assessed adequately.*

What conditions pre-qualify the implementation of an LGF?

The *Decision Tools* specifically require a rigorous market assessment and a clear rationale for using LGFs. The assessment must show that:

- a measurable, quantifiable market demand has been demonstrated
- the guarantee is professionally managed

[3] DCA is owned by USAID with all of its activities managed by USAID's overseas missions; it is priced and financially monitored centrally at USAID's Office of Development Credit in Washington, D.C.

- the guarantee fund institution is an independent, specialized financial institution and its functional modalities have been discussed and defined with the commercial banks and financial service providers (FSPs) that would participate in the credit guarantee programme
- a significant part of the default risk will stay with the retail institution to avoid moral hazard and adverse selection.
- significant technical assistance (TA) is available to mitigate the other constraints and risks involved in serving the target group (e.g. appropriate products and delivery mechanisms, trained staff and risk management systems)
- international good practices for guarantee funds and setting incentives for correct claim and settlement are followed.

Box 1: Development Credit Authority (DCA) experience with LGFs

DCA's experience is that the guarantee does not reduce interest rates. Any benefit of the guarantee in reducing the interest rate risk premium is typically offset by fees that the financial institution passes on to the borrower. The guarantee typically does not address other components of the interest rate cost make-up (i.e. cost of funds and operating costs). However, guarantees generally do serve to:

- lower collateral requirements
- allow banks to lend to borrowers who were otherwise deemed uncreditworthy.

LGF appraisals must emphasize governance structures as a basis for deciding whether to augment the existing capital base out of an IFAD-supported project or programme. This should also be prioritized before launching IFAD-supported interventions. Also, the trust deeds or articles of associations/by-laws of new LGFs must clearly establish an independent management and corporate guidelines for managing LGFs.

As a general rule, credit guarantees are only effective when fully integrated into the existing financial market and managed by finance professionals who know the market well. As indicated in the IFAD's *Rural Finance Policy*, the cost of guarantees to the financial intermediary and the client need to be assessed adequately.

Lessons learned

Before utilizing an LGF, it is important to understand their strengths, weaknesses and the opportunities they present.

Strengths

LGFs are **appropriate for IFAD-specific target groups**. IFAD-specific target groups have difficulty in accessing loans due to the perception that they represent higher risk because they are smaller and/or first-time clients with insufficient bankable collaterals or individual guarantors to a loan contract. LGFs can help reduce this difficulty

LGFs can **secure a portion of borrowers' debts** and, thus, the default risk that the debt constitutes to the FSP. There are broad variations observed internationally for partial guarantees, ranging from 30 to 80 per cent.

LGFs **encourage lending** to a given target group, thus lowering the collateral requirements for loans secured by guarantees.

LGFs can help the *right* formal financial institution lend to the MSME sector if the FSP already has a strategic interest in lending to farmers, microenterprises and small businesses. However, a guarantee alone will *not* be sufficient to encourage a corporate financial institution to enter into small-scale agricultural lending (see Box 1).

Weaknesses

LGFs do not attack the key barriers of access to finance for farmers and rural micro- and small entrepreneurs. In many cases, the **main constraints** that block access to credit are high interest rates and the lack of **relevant products, trained staff** and an **outreach strategy**. Without these outreach pre-conditions in place, an LGF will do very little.

LGFs are often **inadequately capitalized** in terms of loan guarantee portfolios, administrative budget and support budget to cover the costs of running the LGF operations.

Domestic and international donors can distort the smooth functioning of LGFs by using (matching) grants and donations inadequately, prematurely agreeing to indemnity claims and assuming more than their fair share of responsibilities compared to that of the lenders, when valid claims have to be covered by guarantee arrangements.

LGFs experience high **inadequate recoveries by lenders** and **high, unsustainable operating costs** at the different layers of the structure. This can impede the long-term sustainability of LGFs. Where administrative costs are higher than the fees charged and total incomes generated, the LGF is not viable.

In theory, interest rates should be lower but experience has shown that they remain high since the borrower is expected to pay a guarantee fee.

Opportunities

The tailoring of LGF services to loans with a higher developmental impact, which are seen as riskier, creates opportunities at the community level and for the formal financial institutions involved. The multiplier effects of guarantee arrangements leverage additional domestic financial resources out of domestic financial institutions. LGFs are, therefore, an option to address considerations of risks in an environment of high excess liquidity in the financial sector. The higher the multiplier effect, the more responsibility is vested with the partner financial institution.

Where there is high liquidity in the financial sector and when formal financial institutions are averse to taking the risk of banking with lower-income, productive microenterprise or farming units, LGFs can leverage out domestic financial resources.

Clearly, each of these opportunities comes with risks, so project teams must carefully analyse the situation before moving forward. Project preparation needs to identify the reasons for potential partner FSPs not lending to the projected IFAD target group in the “without project” scenario**.**

Lessons learned from IFAD

Target group and impact

LGFs add value to target clients in two ways, by increasing access to financial services and reducing the costs of loans to clients.

Type of guarantees

Because of the generally small size of end loans in IFAD-supported projects, individual guarantees are unlikely to be sustainable since monitoring and initiating them is staff-intensive for the small volumes involved.

Coverage levels

Guarantee coverage should not exceed 50 per cent of the total outstanding loan principal amount of the portfolio. The balance, borne by the partnering financial institution, ensures commitment and reduces the chances of misusing the LGF for carelessly covering outstanding loan positions. DCA, for example, has the authority to guarantee over 50 per cent of the realized loss of principal but only uses it in special cases.

Pricing of guarantees

With smaller transaction sizes typical of smaller IFAD-type clients, pricing becomes an increasing challenge. The business plan and financial projections need to price guarantees realistically. If operational costs and lending risks are not adequately assessed, the price of the guarantee will not reflect the risk and, as a result, the capital of LGF is depleted over time.

Diversification

Clustering of the portfolio and the resulting covariance of risks pose strategic challenges, not just for financial institutions but also for LGFs. It is prudent to have portfolio diversification for a guaranteed portfolio and for an intermediary guarantee to a microfinance institution (MFI) that has previously only focused on microtrading and service loans.

Experiences from other international arenas

Europe

LGFs have a successful track record in developed economies of stimulating the development of the small business sector. For instance, Italy’s Mutual Guarantee Funds made it possible to increase lending to small businesses; today, Italy has an extensive network of credit guarantee schemes federated nationally among 700 agencies. Other positive experiences include Poland (with eight different client group specific LGFs) and the European Mutual Guarantee Association (with 1,900 mutual guarantee societies as members).

Africa

In Nigeria, the Agricultural Credit Guarantee Scheme Fund (ACGSF) was established in 1977 with the aim of increasing the level of banks’ credit to the agricultural sector. ACGSF was designed to address the low recovery rate on agricultural lending that discouraged the banks from granting loans. It provides a refund of 75 per cent of any amount in default (principal and interest), net of any amount realized from the collateral held, to the lending bank. ACGSF also assists farmers with interest payments, with farmers borrowing from the lending bank at market-determined rates and receiving an interest rebate of 40 per cent if they repay their loans on time. A special trust fund mechanism is used as additional collateral for rural farmers to access further loans under the ACGSF from state governments and private organizations.

There are other domestically initiated and designed schemes in Kenya, United Republic of Tanzania and Burkina Faso. The Alliance for a Green Revolution in Africa (AGRA) used US$17 million in loan guarantees to reduce risks of lending by formal financial institutions, with its partners leveraging US$160 million of loan funds from commercial banks in Kenya, Uganda, United Republic of Tanzania, Ghana and Mozambique. AGRA works with national partners to establish guarantees (see Box 2). AGRA has demonstrated true leadership in portfolio monitoring and management, and its on-the-ground, hands-on approach with quarterly meetings with bank staff should be emulated.

United States of America and Latin America and the Caribbean

LGFs with high visibility in agricultural finance operate in Mexico, the *Fideicomisos Instituidos en Relación con la Agricultura* (FIRA, Trust Funds for Rural Development), and in Chile, such as the *Fondo de Garantía para los Pequeños Empresarios* (FOGAPE, Small Businesses Credit Guarantee Fund). In the United States, the guarantees supported by the United States Agency for International Development (USAID) in Latin America are centrally managed to support certain classes of loans from commercial banks. FUNDES, a Swiss NGO established in 1984, started with guaranteeing 50 per cent of small business loans in Panama and Costa Rica, expanding to Bolivia, Argentina and Mexico.

Asia

Guarantee arrangements have been a standard financial instrument in commercial and merchant finance for years. LGFs with a high visibility in agricultural finance operate in India where a Small Industries Bank of India (SIDBI) *Fonds International de Garantie*-designed fund for supporting MSMEs is centrally managed to guarantee small loans of banks to rural and other microentrepreneurs.

Box 2: IFAD – AGRA collaboration on credit guarantee funds in Kenya

"A recent example of the enthusiasm for and impacts expected from loan guarantees can be found in a report by the Alliance for a Green Revolution in Africa (AGRA). It reported using US$17 million in loan guarantee funds to leverage US$160 million through four major lending programmes. This included a US$10 million line of credit that the National Microfinance Bank in Tanzania agreed to lend to agro-dealers at an interest rate of 18 per cent, compared with the typical rate of 46 per cent charged by MFIs. In Kenya in 2008, AGRA and IFAD provided US$2.5 million each as a loan guarantee that leveraged US$50 million from Equity Bank. As of May 2009, the programme had loaned more than 679 million Kenyan shillings (about US$9.8 million) to almost 20,000 small-scale farmers. The bank reportedly hired 100 new staff to expand and improve the programme's outreach and effectiveness. In March 2009, Standard Bank in Africa agreed to offer US$100 million in loans to smallholder farmers and agricultural businesses: US$25 million each went to Ghana, Mozambique, United Republic of Tanzania and Uganda. With several contributing partners, AGRA developed a loan guarantee fund of US$10 million for these loans." (AGRA 2009).

Guidance for design and implementation

Preconditions for IFAD support to LGFs

The IFAD's *Rural Finance Policy* and *Decision Tools for Rural Finance* give guidance on when it is appropriate to include LGFs in an IFAD intervention. Given the limited success with guarantee funds, the PDT must make a strong case for the use of an LGF. In addition to performing a rigorous market assessment and providing a clear rationale, the PDT and the CPM need to show that certain basic conditions are met for the LGF to be successful.

Demand for loans

There must be sufficient, demonstrable, measurable and quantifiable market demand by MSMEs that warrants the loan guarantee. A preliminary market survey will be useful in answering this question. If there is no demand for credit, there would be no merit in starting an LGF scheme.

Supply of loans

Credit service supply must be assessed. As a general rule, initiating a new system is **not** merited if there are other credit guarantee systems in the target area that could provide the same services as IFAD or there is another system providing services that would cover IFAD's target groups.

Availability of professional management

LGFs require experienced technical managers and training before initiation.

Adequately prepared and independent guarantee fund institution

A guarantee system will only be sustainable if the fund managing institution is fairly independent with specialized staff. Functional modalities should be discussed and defined with the commercial banks and FSPs that would participate in the LGF well in advance.

Availability and adequacy of technical assistance

An LGF is only sustainable in experienced hands. As a general rule, an LGF is unwarranted if there is: (i) inadequate technical expertise; (ii) no risk mitigation and management system in place; or (iii) no appropriate procedures and products to address the demand.

Appreciation of the international best practices

What is the level of appreciation, understanding and likely adoption of international best practices in guarantees? As a general rule, **no** LGF system is warranted if: (i) local policies conflict with international best practices; or (ii) staff are unaware of international standards (e.g. accounting systems) and/or are unlikely to adopt any.

Availability of excess liquidity in local banks

Do local formal financial institutions have the required liquidity to advance to IFAD clients and are they willing to take part in the scheme? Otherwise, they cannot be granted guarantees.

Potential for sustainability

If the PDT notes any “signals” of unsustainability, the LGF must be halted.

Designing the LGF systems

Once the PDT is convinced that the preconditions and necessary elements are met as above, the design phase follows. This section provides a guide to identifying the needs of the target clients and choosing the most appropriate and suitable LGF type. Because rural finance projects are complex, this guideline provides references to resources. As a rule of thumb, while the intervention should be long term, there is no one-size-fits-all approach to designing guarantees. The guidance is thus flexible for discussion, dialogue and innovation.

Key steps in designing LGFs

Step 1: Assess the micromarket in detail

Perform a demand assessment and a supply assessment. Demand assessment will identify: (i) the LGF types, products, services and needs important to the target group; (ii) the types of clients in the region; and (iii) identify the needs of each specific client type. Supply assessment will identify: (i) strength and weaknesses of existing FSPs and how they meet available demand; and (ii) the opportunities and threats to FSPs. As a rule of thumb, the LGF should **not** proceed if: (i) the target groups’ interest and priority differ with those of the available funds; (ii) the clients differ from the typical SMEs or IFAD’s typical target groups; (iii) the available products and services from the existing FSPs are able to meet demand and are strong enough to sustain it in the long term.

Step 2: Assess the meso-market[4]

Identify: (i) the main actors and activities in the infrastructure of LGFs, including domestic rating agencies, credit bureaux, audit firms, deposit insurance agencies, technical service providers, professional certification agencies, associations and apex organizations of FSPs; (ii) the strengths, weaknesses, opportunities and threats (SWOTs); (iii) other risk-mitigation techniques at the meso level, such as barriers to entry and participation of smaller FSPs and even of licensed banks operating exclusively in rural areas.

The design should **not** proceed if: (i) there is a complete absence of regulatory and other support actors (e.g. credit bureaux, services providers); (ii) the threats override the strengths and opportunities; or (iii) there are no risk mitigation mechanisms in place at the meso level.

©IFAD/Franco Mattioli
Panama – Agricultural Credit Project

Step 3: Assess the macro-market[5]

Assess and identify relevant contextual, policy and regulatory issues likely to affect LGFs. In addition, assess whether the policy framework is adequate to allow credit guarantees to flourish (see Zander 2013).

Step 4: Staff training and management development

Banking environments have become very specialized; competition in rural banking is fierce, resulting in reluctance to open doors to donors that do not come with significant capitalization or lending funds. In case the staff training has not been affected, the LGF should be halted until the right staff are trained and the right skills are available.

[4] See IFAD *Rural Finance Policy*, p. 23, Table 5 at www.ifad.org/ruralfinance/policy/index.htm.
[5] See ibid, p. 26, Table 6.

Step 5: Assess the feasibility of the LGF

Generally, LGF design should **not** proceed if: (i) the size of the potential market for MSME lending is too small; (ii) formal financial institutions and other private operators are unsupportive and have no interest in the planned LGFs; and/or (iii) there is a lack of or an inadequate and inappropriate legislative and regulatory framework.

Step 6: Assess resource requirements

The failure to estimate the necessary resources required will lead to limited results. Thus, the design team must ensure the availability of the necessary resources. The LGF should **not** proceed if resources are lacking for preliminary activities (e.g. market assessment, staff training and procurement of equipment).

Step 7: Design the monitoring and evaluation (M&E) system

Ensure that the LGF has a robust M&E system that can track performance of FSPs and identify areas that need added attention. The design of the M&E system should begin in the early phases of the overall project design. As a rule of thumb, key benchmarking indicators and baseline data must be available before implementation starts.

Implementation of the LGFs

This section identifies the steps for implementing LGFs. From the beginning, it is important to formulate a timeline and collect baseline information to allow comparison with results from subsequent surveys.

Start-up phase

Step 1: Confirm stakeholder interest in the establishment of the LGF

This should provide clear indications regarding: (i) the volume of resources that could be mobilized for capitalization of the scheme; and (ii) the preference for the legal form to be adopted (e.g. an independent legal entity, having corporate status, or a government facility, either placed under some ministry or attached to a parastatal).

Step 2: Consult with commercial financial institutions

Explore their willingness to contribute financially to the establishment of the fund. Ideally, the amount of the contribution of formal financial institutions should be broadly compatible with the financial strength of those operating in the country and justified by the benefits that these institutions would derive from the LGF.

Step 3: Consult with private sector associations and business leaders

Ascertain their willingness to contribute financially to the scheme. The participation of private sector organizations adds legitimacy to the initiative.

Step 4: Understand licensing and regulatory aspects of the project

Having the support of the regulator is an absolute precondition for the success of the initiative, and each aspect of the proposed operation should be discussed in detail. Verify the appropriateness of the regulatory and legislative framework and, if necessary, propose new regulations and laws or amendments to existing ones.

Based on the results of the above steps, it should be possible to determine the size of the LGF, its shareholding structure, the legal form to be adopted, the licensing procedure to be followed and the key regulatory parameters (magnitude of the multiplier, provisioning rules) that would impact on LGF operations. It is not easy to estimate the time required to complete the foundation phase since some steps are political in nature and others involve negotiations. Some steps could be carried out in parallel to allow for iteration. In broad terms, the start-up phase could take between one and six months, depending on the political will of the authorities and the attitude of actors.

Operational phase

Activities include: (i) formation of the LGF, (ii) preparation of the legal and operational documents; (iii) accomplishment of licensing formalities; (iv) recruitment of personnel; and (v) finalization of framework agreements. The process is divided into six steps, as follows:

Step 1: Prepare legal documents, incorporate the fund, mobilize capital and appoint directors from private sector

This will involve all parties, and include: (i) the LGF charter and related documents (e.g. shareholders' agreement, in case formal financial institutions and other private sector organizations accept to participate); and (ii) LGF key policy documents (namely, the mission statement and guarantee policy). The latter would be required even in the case the LGF is not established as a separate legal entity but rather as a government agency. This is followed by the allocation of funding through the appropriate procedures (e.g. budget appropriations) and appointment of a managing committee.

Step 2: Formulate the full-fledged business plan and financing model

In particular, the business plan should: (i) confirm the viability of the initiative in the light of possible modifications introduced in the basic model described here; and (ii) be structured in accordance with requirements for licensing. This may require further elaboration of LGF policy documents (e.g. the guarantee policy and the investment policy).

Step 3: File the licence application and mobilize human resources

This will include all the necessary supporting documentation (e.g. business plan and financial model and risk management policies). Regarding human resources, this includes recruitment of personnel and training, as well as the appointment of the implementation team. This is carried out in parallel with the establishment of the operational office, procurement of equipment, etc.

Step 4: Develop operational tools and procedures

This will include: (i) preparation of legal documents required for operational activities (framework agreements with formal financial institutions, model guarantee contracts, etc.); (ii) development of management information and accounting system (MIS); (iii) formulation of operational and control procedures; and (iv) preparation of a marketing and communication plan.

Step 5: Finalize negotiations

Formulate, negotiate and sign agreements with the formal financial institutions dedicated to supporting certain categories of clients and prepare for final operational activities (e.g. testing of MIS). Partners may include non-governmental organizations (NGOs), parastatals and private providers or business development services.

Step 6: Implement performance-based agreements, monitoring and reporting

This will provide information on: (i) the extent to which FSPs or delivery mechanisms reach the target market (depth); (ii) the number of clients served (scale); and (iii) the degree to which they do so equitably, sustainably and legally. Closely monitor the implementation of activities and performance of participating FSPs. Collect key financial and social performance indicators for partner FSPs on a quarterly basis in order to make day-to-day project management decisions. Collect and submit to IFAD headquarters on an annual basis the overall performance of the LGF project, as well as of the Fund's overall portfolio, using key indicators for rural finance.

Scaling up – LGFs in rural finance

When considering scaling up of LGFs, it is important to consider available types of guarantees: individual guarantees as well as loan portfolio guarantees for formal financial institutions that serve the small farming or business sector. In addition, there are a wide range of other types of guarantees that are normally used more in corporate finance such as portable and bond guarantees.

Similar to LGFs, scaling up should be carefully considered. IFAD's *Decision Tools for Rural Finance* stresses that IFAD-supported projects have had very limited success with guarantee funds. Only in a few cases have guarantee funds been effective in opening access to credit among IFAD's target groups. Therefore, any scaling up of LGFs should be based on lessons learned from successful case studies.

Capacity-building should be a key element in up-scaling the LGFs. The FSPs should be trained and their capacity built to make them more attractive bank clients.

Since IFAD's passed experience with guarantee funds is weak, as a standard procedure any scaling up must also include a rigorous market assessment considering the safe minimum standards established in IFAD's *Rural Finance Policy*. It is helpful to think of FSPs (i.e. MFIs) on a continuum of sophistication. Scaling up should only be used with highly sophisticated MFIs (Tier 1–2). Less sophisticated MFIs (Tier 3-4) require more assistance for sustainability (see Box 3). Also, use tailored risk-sharing solutions.

IFAD scaling-up design has to assess, on a case-by-case basis, whether LGFs would be an adequate option for its principal mandate. The scaling up will take place when the participating banks incorporate systemic changes in their policies for wholesale and retail lending to the agricultural sector along the value chain, small rural enterprises, smallholder farmers, women and youth.

Projects must demonstrate these systemic changes in order to qualify for continued access to LGFs.

Box 3: Tailored risk-sharing solutions

- The facility will cover a percentage of the lending portfolio of a formal financial institution to agricultural loan beneficiaries.
- The guarantees will take the form of a letter of comfort and claims will be made only when there are actual losses realized on the portfolio.
- The risk-sharing facility will consider: the volume of lending; the part of the value chain that the formal financial institution is lending to; the terms of lending; the type of institution, experience and capacity for agricultural lending; and commercial conditions such as interest rates, guarantee and collateral requirements.
- First loss arrangements for formal financial institutions that want to lend to the smallholder agricultural sector or a clear long-term commitment to the sector by employing dedicated staff or other investments.
- Shared-loss arrangements will only be used for lending to agro-dealers, seed companies, fertilizer companies, equipment leasing entities, agroprocessors and millers, etc., or to medium-scale commercial farmers.
- The risk-sharing facility will be managed by formal financial institutions at a fee. The guarantee fee will be set at a level based on financial economics of the fund.

The participating bank's level of comfort to the agricultural sector must be enhanced during the programme and the bank must be willing to lend to the sector even without such an LGF. This will allow the leveraging of funds of several other donors and investors to complement the funding from IFAD.

The scaling up should also look for alternative pro-poor financial graduation systems to help grow the credibility/bankability of the MSMEs of the targets first before launching them on to market-based lending facilities.

©IFAD/G.M.B.Akash
Bangladesh - Microfinance and Technical Support Project

Frequently asked questions

Q: What are concrete alternatives for risk-mitigating mechanisms for banking with IFAD's target groups?

A: Established instruments such as effective and inclusive national reporting systems on arrears and delinquencies on loans of all sizes are another meso-level rural finance support mechanism, just like an LGF. Internally, FSPs have various options for risk mitigation through internal ratings, etc. Finally, there are other instruments for mitigating the default risk, as evidenced in the various different techniques in microfinance to substitute formal collateral with other techniques, such as joint liability.

Q: Should LGFs be designed for a specific region or nationally?

A: Even though there are many examples of locally (e.g. the municipal level) operating LGFs, scale economies and the need to provide similar support instruments to potential recipients within one economy have recently resulted in clearer recommendations to operate LGFs nationally (Association européenne du cautionnement mutuel [AECM], 2004).

Q: What is wrong with a multi-purpose set-up where the guaranteeing agency also provides capacity-building, investment advice and perhaps even loans to the same target group?

A: The management and monitoring of LGFs is complex and requires full and specialized management attention.

Q: How does an LGF finance its operations?

A: LGFs are capitalized with: (i) revenues from operational activities (i.e. guarantee fees and interest accruing on deposits–basic model 1, section 1); (ii) membership fees if the guarantee fund association is mutual or incorporated as a cooperative (e.g. in Italy); and (iii) grants and donations in developing economies often sourced from international donors.

References

AECM. 2004. *Guaranteeing loans for small and medium enterprises – sharing credit risks, an incentive for investment and growth*. Brussels, Belgium: Association européenne du cautionnement mutuel (AECM).

AGRA. 2009. *Early accomplishments, foundations for growth*. Nairobi, Kenya: Alliance for a Green Revolution in Africa (AGRA).
http://www.agra-alliance.org.

Bannock, Graham and Partners Ltd. 1997. Credit guarantee schemes for small business lending: a global perspective. London, England.
http://cec.shfc.edu.cn/download/20100925104414_239846439874.pdf

Dougherty, J. 2011. The use and misuse of credit guarantees for rural finance. Paper presented at Cracking the Nut Conference, 20-21 June 2011. Washington, D.C.: World Bank.

Flaming, M. 2007. *Guaranteed loans to microfinance institutions: How do they add value*? Focus Note January 2007. Consultative Group to Assist the Poor (CGAP).
http://www.cgap.org/sites/default/files/CGAP-Focus-Note-Guaranteed-Loans-to-Microfinance-Institutions-How-do-they-add-Value-Jan-2007.pdf.

IFAD. 2009. *Rural Finance Policy*. Rome: IFAD.
http://www.ifad.org/pub/basic/finance/eng.pdf

IFAD. 2010. *Decision Tools for Rural Finance.* Rome: IFAD.
http://www.ifad.org/ruralfinance/dt/full/dt_e_web.pdf

ILO. 2004. *Guarantee fund for small enterprises – a manual for guarantee fund managers*.
http://www.ilo.org/public/English/employment/finance/download/guarfund.pdf

Meyer, R.. 2011. *Subsidies as an instrument in agriculture finance. A review*. Joint Donor CABFIN Initiative. Washington, D.C.: World Bank.

Zander, Rauno, Calvin Miller, and Nomathemba Mhlanga. 2013. *Credit guarantee systems for agriculture and rural enterprise development*. Rome: FAO.

Additional resources

- Many of the arguments for and against guarantee funds can also be found in Llisterri, J.J. and Levitsky, J. eds. 1996. Sistemas de Garantias de Credito: Experiencias internacionales y lecciones para America Latina y el Caribe, Banco Interamericano de Desarrollo. Washington, D.C. An English version is found in The Financier 4: 1 and 2, February/May 1997. Several of the articles also appear in Small Enterprise Development 8: 2, July 1997.

- For results of a nationwide bank training measure of KfW in India, see Zander. 2011. *KfW Technical Assistance Measure.* National Bank for Agriculture and Rural Development, Final Report, Line X, 2008–2010. Mumbai, India.

- A recent CABFIN (Capacity Building in Rural Finance Partnership) publication details the experience of IFAD in Kenya with a guarantee fund arrangement through the Alliance for a Green Revolution in Africa (AGRA, 2009).

International Fund for Agricultural Development
Via Paolo di Dono, 44 - 00142 Rome, Italy
Tel: +39 06 54591 - Fax: +39 06 5043463
E-mail: ifad@ifad.org
www.ifad.org
www.ruralpovertyportal.org
ifad-un.blogspot.com
www.facebook.com/ifad
instagram.com/ifadnews
www.twitter.com/ifadnews
www.youtube.com/user/ifadTV