

# Loan guarantee funds

## Inclusive rural financial services



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Mali - Village Development Fund  
Programme - Phase II

## Introduction

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

LGFs: The How To Do Note identifies best practices in the implementation of LGFs, describing the challenges, weaknesses, opportunities and lessons learned in developing the capacity and outreach of rural finance institutions.

## Background and context

IFAD's practical experience with LGFs is limited. IFAD's *Decision Tools for Rural Finance* (2010) is the primary guide in determining whether to use LGFs in an IFAD-supported programme. An LGF may be an appropriate instrument when:

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

### What is an LGF?

An LGF is a non-bank financial instrument 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.

Essentially, a loan guarantee is a commitment by a third party to cover all or some of the risks associated with a loan to its client, 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.

An LGF 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.

## Rationale

Only in a few cases have IFAD-supported LGFs been effective in opening access to credit among IFAD's target group. Most often, commercial banks do not lend to FSPs due to high opportunity costs and the establishment of a guarantee fund alone will not overcome the problem. IFAD funds are often better used to build the capacity of FSPs to make them more attractive bank clients.<sup>1</sup> More sophisticated FSPs are typically excellent candidates for guarantees, while less sophisticated ones require more assistance than a guarantee to approach sustainability. In any case, a clear rationale for using an LGF needs to be established before it should be considered.

An LGF is most appropriate when the lender bank is at an advanced development stage, highly liquid and high-performing (i.e. low PAR>30), sees lending to microfinance institutions (MFIs) and other FSPs as a growth market, and aims to achieve/expand commercial sustainability. LGFs with few restrictions – e.g. those that do not specify what sector/region the guaranteed loans must be used for – tend to function more smoothly.

The background and context of the How To Do Note provides a situational analysis of the general current practice in credit access in rural areas and specifically of LGFs. Overall, it seeks to answer the following questions, inter alia: *How do rural enterprises finance their businesses? What are the facilitators and inhibitors for rural finance? How do small and medium-sized enterprises (SMEs) in developing countries access rural finance? What role do formal financial institutions play in rural finance?*

The How To Do Note also provides the rationale for LGFs, the general justifications and requirements for the development of guarantee schemes. The contextual analysis determines the opportunity costs in the absence of robust credit markets in developing countries, including the impediment of sustained economic growth and productive development. The knowledge document also compares credit access among entrepreneurs, small businesses and individuals in developed and developing countries.

## Summary of past experience

Well-designed LGFs can reduce the difficulty of accessing loans for smaller, riskier and first-time clients who demand working and investment capital, and who have repayment capacity but lack sufficient bank-worthy collateral. There are two, often-quoted strengths of LGFs: they lower the risk of loaning to small business and make it more attractive by absorbing it.



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<sup>1</sup> A recent Capacity Building in Rural Finance (CABFIN) Partnership publication details the experience of IFAD in Kenya with a guarantee fund arrangement through the Alliance for a Green Revolution in Africa (AGRA).

## Strengths of loan guarantee funds

- LGFs can reduce the difficulty of a particular target clientele in accessing loan financing because of the higher risk they seem to represent (as smaller and first-time clients with insufficient bankable collaterals). They are suited for IFAD's target groups of farmers and rural MSMEs.
- LGFs can secure a portion of the borrower's debts to FSPs and, thus, the default risk that the debt constitutes. Broad variations are observed internationally for partial guarantees ranging between 30 and 80 per cent of the outstanding principal loan amount.
- LGFs lower risks generated through guarantees, enabling formal financial institutions to offer lower interest rates for loans.
- If properly targeted, an LGF can help formal financial institutions lend to MSME sectors.

## Challenges and weaknesses of LGFs

LGFs do not address the key barriers of access to finance for farmers and rural micro- and small entrepreneurs. In many cases, the **main constraint** at the lender level that blocks access to credit is **the lack of relevant products, trained staff** and an **outreach strategy**. When these outreach preconditions are in place, the guarantee can help the right bank lend to these sectors but the bank must have a strategic interest in lending to farmers and micro- and small enterprises. However, a guarantee alone will not be sufficient to encourage a corporate bank to enter into small-scale agricultural lending.

- LGFs are **inadequately capitalized** in terms of the loan guarantee portfolio and the administrative and support budget to cover the running costs of LGF operations.
- Domestic (i.e. local and national governments) and international donors can distort the smooth functioning of LGF arrangements by using grants and donations inadequately, prematurely agreeing to indemnity claims, and assuming more than their fair share of responsibilities when valid claims have to be covered by guarantee arrangements.
- **Inadequate recoveries** of the guaranteed portfolio and **high and unsustainable operating costs** at the different layers of the guarantee structure can significantly impede the long-term sustainability of an LGF. Where administrative costs are higher than the fees charged and total incomes generated, the LGF as a corporate entity is not viable.
- At the borrower level, there is the risk of **moral hazard**, particularly for individual guarantees and separate clauses to be signed in the credit contract. Experience from the Development Credit Authority (DCA) of the United States Agency for International Development (USAID) shows that this can be avoided by explaining to the lender that borrowers should not be aware that their loan is under guarantee. However, borrowers are expected to pay fees, usually a guarantee fee and an annual administrative fee. Considering the Client Protection Principles in Microfinance, which IFAD endorsed in 2008, the borrowers should be informed of the existence of the LGF. Lenders often transfer the fees onto borrowers through higher interest rates.
- Costs to the borrower (interest rates on loans) have not dropped significantly despite lowered risk to the FSP.





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## Lessons learned

- **Target group and impact:**  
LGFs can add value for the target clients in two ways: by increasing access to financial services and reducing the costs of loans to clients.
- **Type of guarantees:**  
Monitoring and initiating the guarantees is staff-intensive for the small volumes involved, often making them unsustainable.
- **Coverage levels:**  
Guarantee coverage should not exceed 50 per cent of the total principal loan amount in the portfolio outstanding.
- **Pricing of guarantees:**  
Small transaction sizes make it a challenge to price them properly.
- **Europe:**  
LGFs have a successful track record in developed economies in stimulating the development of SMEs. For instance, Italy's Mutual Guarantee Funds made it possible to increase lending to SMEs; now, Italy has an extensive network of credit guarantees schemes federated nationally among 700 agencies.

- **Africa:**  
In Nigeria, the Agricultural Credit Guarantee Scheme Fund (ACGSF) aims to increase the level of bank credit to the agricultural sector. Designed to address the low recovery rate on agricultural lending, which was discouraging the banks from lending, a refund of 75 per cent of any amount in default (principal and interest) net of any amount realized from the collateral held is made to the bank. As the specialized LGFs in Nigeria show, clustering of the portfolio and resulting covariance of risks pose strategic challenges not just for financial institutions but also for the LGFs.
- **North and South America and the Caribbean:**  
LGFs with high visibility in agricultural finance operate in Mexico, such as 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). USAID-supported guarantees in Latin America are managed centrally to support loans from banks.
- **Asia:**  
Guarantee arrangements have been a standard financial instrument in commercial and merchant finance for years; in India, these arrangements have been widely used in agricultural finance.

## Summary of key issues

### Key for successful LGFs

#### **Governance arrangements:**

Reviewing existing arrangements and providing technical assistance in setting up new and specialized LGFs are key in the preparation of a development intervention involving loan guarantees. Articles of association and trust deeds, and a separate business plan with financial projections as part of the project design process should be finalized. A detailed manual of guarantee fund systems and procedures should be drafted according to the strong governance arrangements.

#### **Minimum guarantee portfolio:**

Undercapitalization is one of the major sustainability risks associated with guarantee arrangements. The minimum capitalization for a guarantee fund depends mainly on the following factors:

- geographical coverage area and expected number and average amounts of loans covered
- loan tenor of guaranteed loans
- maximum value (percentage) of guaranteed loans
- reasonable expectations on default levels
- realistic financial projections of the fund balance sheet (indemnities) and income expenditure differentials (projections of net incomes or losses).

#### **Treatment of grants and donations:**

Grants and donations are added to the capital costs and should **not** be used to cover operational costs. However, the initial capitalization and coverage of start-up costs may be donor-funded.

**Borrower contributions:**

Borrowers pay an initial guarantee fee, an amount to be paid to obtain guarantee coverage, and, in some cases, they are also expected to pay an annual administrative fee.

## Challenges, opportunities and benefits

Tailoring LGF services to loans with a greater developmental impact, which are considered riskier, creates opportunities at the community level, as well as for the banks 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.

Lines of credit (LOCs) should generally be avoided as an instrument to channel loan funds to IFAD-targeted client groups. Where there is high liquidity in the financial sector but banks are averse to taking the risk of banking with lower-income, productive microenterprise or farming units, an LGF may be an option to leverage out domestic financial resources. Project preparation needs to identify the reasons for potential partner FSPs not lending to the projected IFAD target group in the “without project” scenario.

## Brief description of the LGFs toolkit<sup>2</sup>

⇒ **Teaser:** Sets out the scope (you are here).

**How To Do Note:** Conceptualizes key issues and provides guidance for design and implementation.

**Lessons Learned:** Provides lessons learned and experiences.

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<sup>2</sup> All toolkits can be found at <http://www.ifad.org/knotes>



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