Enterprise and Cooperative
Development Department

Poverty-oriented
Banking

Working paper
No. 18

Guarantee Funds and NGOs: Promise and Pitfalls

— A Review of the Key Issues —

Michiel Bastiaenen
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International Labour Office Geneva

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Acknowledgement

This Working Paper is the result of an ILO project (“Self-Managed Guarantee Funds”, INT/91/M06/NET), carried out jointly from 1992 to 1995 with RAFAD, a Swiss Foundation.

Michiel Bastiaenen (ILO) prepared the first draft, which was subsequently updated and edited by Peter van Rooij.

INTRODUCTION

There is a renewed interest in guarantee funds, which is unusual. Not long ago, this instrument was discorded as useless and inefficient. A closer look reveals, however, that this applied more to centrally administered public guarantee funds, strictly targeted and under portfolio restrictions, often bureaucratically managed, but not all guarantee funds are like that.

This document focuses on different types of guarantee funds, namely small guarantee mechanisms operated by NGOs comprising private voluntary organisations (PVOs) and self-help or member-controlled organisations (SHOs).

The document has been written to serve NGOs which are operating small, decentralized guarantee schemes or are considering to do so in the near future. For NGO managers it should be a tool to identify areas in which institutional upgrading may be required. This guide will also be useful for donor agencies which support NGOs in micro finance.

The findings have been largely drawn on the experiences of the inter-regional ILO project "Self-Managed Guarantee Funds" (INT/91/M06/NET) and the "Assistance to Business Creation" project in Kenya, both funded by the Government of the Netherlands.

The project "Self-Managed Guarantee Funds" started in October 1992 as a joint initiative of the Poverty-Oriented Banking Unit of the ILO and the Swiss Foundation for Research and Application of Alternative Financing for Development (RAFAD). The project aimed at the empowerment of NGOs in managing guarantee funds and to facilitate access to bank credit for their members/ clients. Six organisations: MCCH (Ecuador), CIPDEL (Peru), UGC (Mozambique), ORAP (Zimbabwe), CSC de Gitarama (Rwanda) and PRDA (Sri Lanka) received a "seed" guarantee fund in the range of US$ 25,000 - US$ 80,000. The experiences of these six NGOs have yielded insights into a variety of issues related to the management of guarantee funds, as reflected in this document.

1. GUARANTEE FUNDS

1.1 Basic features

Loan guarantees enable access to loans

A guarantee fund provides a *loan or credit guarantee,* i.e. it enables a borrower to approach a bank for a loan. Guarantees are particularly useful for borrowers who do not have sufficient collateral, such as land or other assets. Small borrowers almost always lack (sufficient) collateral. Therefore, the purpose of loan guarantee schemes is to share the credit risk with the bank.

Three parties

Three parties are involved: the guarantor and the bank conclude a guarantee agreement. A guarantee agreement provides the lending institution with the right to call on the guarantee to recover loan losses. The bank issues a loan contract with the borrower. The borrower subscribes to a guarantee request to the guarantor.

The individual model

In the individual model borrower and the bank are directly linked (see diagram 1). The guarantor and the bank establish a cooperation agreement on the degree of risk sharing. The guarantor may also provide technical support services. The guarantor issues a guarantee certificate or letter of recommendation to the bank. The bank appraises the loan application and, if approved, establishes a loan contract with the client.

The intermediary or "retail" model

In this model, standby letters of guarantee are provided by an international organisation to enable a local organisation to access bank loans or overdrafts for on-lending to their members/clients. There is no loan contract between the bank and the borrower.

The guarantor is an international, specialized guarantee institution (for instance RAFAD, ACCION, WWB).

The bank only deals with the NGO.

Membership organisations using loans or overdraft facilities obtained through external (stand-by) letters of guarantee finance services to their members, like input supply and marketing services which may lead to substantial cost reductions, while enabling the intermediary to generate revenues to cover interest costs and other bank charges.

> The Ecuadorian foundation MCCH represents a movement of around 400 producer and consumer associations and has some 260,000 members spread over the country. During a period of four years the organisation used RAFAD letters of guarantee for bank overdrafts with a commercial bank, which were used for the bulk purchase of primary consumer commodities like rice and sugar. Once purchased, these products were then distributed through the organisation's 17 provincial warehouses to the 300 affiliated community shops in the country, where these goods were sold to low income groups at cost price. One of the major advantages of this mode of financing was the immediate access to credit whenever finance was needed. A total of 13 consecutive loans of 90 days were taken during this period.

DIAGRAM 1 : MODELS OF NGO GUARANTEE FUNDS

I. *Individual model*

NGO Guarantee Fund ----------------Bank

Clients/Members

II. *Intermediary or retail model*

External Guarantor

NGO ______________________________ Bank

Clients/Members

III. *Two-tier model*

Re-insurance entity

Regional/Local -------------------- Bank
guarantee entity

Clients/Members

_________ lending relation (first tier) -------- guarantee ++++++++ second tier guarantee

Guarantee funds as insurance funds

Guarantees are backed by a guarantee fund,[1] i.e. money to be used in case a loan is not paid back in time and the guarantee is called. This fund can be deposited in an account with the same bank, or with another bank.

NGOs as guarantors

Not all guarantee funds are owned and managed by local, private, not-for-profit organisations such as support NGOs, producer associations, cooperatives or grass root organisations. Other types of guarantee funds are run by local or regional authorities to support micro or small enterprises of a particular region or sector.

And not all NGOs own the funds they use for issuing guarantees; the following types can be distinguished:

1) Self-Help Organisations which have created their own guarantee funds on the basis of member contributions with the aim to issue (credit) guarantees only to their members. An example is the mutual guarantee association.

2) Self-Help Organisations and PVOs which have received donor grants to constitute guarantee funds for their members, respectively clients. Here, the ownership is unclear, hence the incentives to use the funds diligently. The NGO acts as a guarantor on behalf of an external guarantee entity, which agrees to issue a standby letter of guarantee to a local bank under risk-sharing conditions.

3) NGOs own the guarantee fund which is topped up by a standby letter of guarantee issued by an external organisation to the local bank. In this set-up, the local organisation operates both guarantees (its own guarantee fund and external letter of guarantee) under one single arrangement.

Probably, the accountability of the NGO operating a guarantee programme varies with onwership. Incentives to perform are expected to be higher when a larger proportion of funds are raised by the NGO organisation and its members.

[1] One exception to this rule is found in case governments commit themselves to reimburse banks for loan losses according to an agreement established for this purpose. Levitsky, 1993.

1.2 Guarantee and revolving loan schemes

Most started out with micro credit schemes. Guarantee schemes came later. What explains this interest?

Linkage building: additionality and graduation

Guarantees help *building linkages* between small "unbankable" borrowers and formal financial institutions. Guarantee schemes seek to create *additionality of lending*, i.e. to induce banks to lend to clients who otherwise would not be eligible for bank credit.

The familiarisation of the bank with the client should eventually lead to the "graduation" of the borrower.

THE VALUE ADDED OF LOAN GUARANTEE SCHEMES

- linkage building: additionality and graduation
- transfer of loan administration to the bank
- potential of leverage

CLIENT GRADUATION: THE INHERENT DILEMMA

Graduation of the best clients is likely to lead to deterioration of the portfolio.

This applies less to guarantee schemes run by membership organisations like producer associations, cooperative organisations and grass root organisations. A “graduated” member will remain a member.

For a bank client graduation may increase costs and risks, at least temporarily. On the one hand, the bank has to rely on the client’s collateral alone, which may be generally more costly to execute.

To resolve the guarantor’s disincentive, donors and/or governments may offer temporary financial compensation to NGO guarantee schemes with a high rate of graduation.

Transfer of loan portfolio administration to the bank

Many guarantee schemes are administered by banks. This reduces costs for the NGO. the NGO is not involved in cash operations. Guarantee fund capital will only be affected in case the bank makes a claim for loan losses. A guarantee fund can be deposited in an interest bearing account, thus generating income. In addition, guarantee funds can be easily protected against the erosive effect of inflation. Cash or current account reserves are not required to the same extent as in direct lending, so - assuming that interest rates received on the guarantee fund will be positive in real terms - inflation affects guarantee funds less dramatically.

1.3 Management constraints for NGOs

In spite of the advantages, local guarantee funds in practice often tend to remain small and relatively ineffective in terms of outreach and graduation; they can easily become a financial burden for their host if costs are not matched by revenues.

The management requirements for guarantee funds are often underestimated. The organization’s staff does not have enough expertise. This leads often to inadequate planning, unsatisfactory collaboration with a bank and general ineffectiveness.

This paper seeks to address these concerns. It is meant as a guide to NGOs who wish to consider the introduction of a guarantee scheme and to others which operate a guarantee scheme but with mixed results. Some of the questions are: What makes a NGO a suitable host structure for this instrument? What should a NGO expect from a guarantee fund? What are the minimum conditions in the environment to make this a viable instrument? What does collaboration with a bank require from a guarantor?

2. FACTORS OF SUCCESS

2.1 External factors

EXTERNAL FACTORS

- financial sector development
- local banking network
- inflation

Financial sector development

The development of the financial sector determines the possibility to find suitable banking partners for a guarantee fund. Financial markets in developing countries are:

- often dominated by state banks. The sustainability of such a partnership can be seriously questioned, as financial sector reform may, sooner or later, (have to) take place. Such restructuring is likely to lead to the reorganization, privatization or even liquidation of these banks with dramatic implications for the guarantee funds;

- in countries emerging out of financial sector reform, it is also difficult to find bank partners for guarantee schemes, since monetary policies and central bank regulations are likely to enhance credit rationing. In these situations, banks are even more hesitant on small scale lending;

- in more developed financial markets, with a wide range of local and foreign banks competing in a limited market and eager to capture new market segments, it should be easier to identify bank partners interested in a guarantee scheme. In practice few developing countries have reached this state and hence downgrading of bank services as a result of increased competition is still rare.

Local banking network

Some grassroots organisations and support NGOs operate in areas where the closest bank branch may be several hours drive away. Under such circumstances a direct client-bank relationship is difficult. Alternative credit mechanisms may have to be developed. The retail model in which the NGO on-lends through its own loan disbursement system may be an alternative. Such intermediation requires a high degree of professionalism and a certain level of specialization, conditions which are not always met by NGOs.

Inflation and exchange risks

Inflation is another factor which constrains the implementation of guarantee programmes. Inflation forces banks to raise nominal interest rates, in many cases real interest rates as well. High real interest rates increase the risk of business failures and loan defaults. Repayment difficulties can easily result in a debt trap as a result of rapidly accumulating interest costs and other charges. The lender and, to a certain extent, also the borrower may prefer short maturities and smaller loans. Although this may decrease the default risk, loan losses to be assumed by a guarantor in a period of high inflation will still be considerable. High inflation can also lead to the erosion of fund capital if the fund is placed in an account with a negative real return. Finally, high inflation may rapidly erode the negotiated leverage with the bank, if the guarantee fund is expressed in hard currency, but the credit line obtained under the guarantee arrangement is nominated in local currency. This problem can be countered by periodic renegotiations of the terms of a guarantee agreement.

2.2 Internal factors

> ***INTERNAL FACTORS***
>
> - target group selection
> - management capacity
>   . institutional culture and leadership
>   . organisational structure
>   . strategic and operational planning capacity
>   . financial policies and procedures
>   . monitoring and control
>   . staff management capabilities
> - programme sustainability

Often NGOs engage in the management of credit guarantee programmes without adequate preparation. Many NGOs originally started as welfare-oriented organizations and only at a later stage became involved in financial intermediation.

Three of the more critical factors in the preparation and operation of a credit guarantee programme are target group selection, portfolio management and programme sustainability.

Target group selection

The guarantor should manage the risk of its portfolio of clients just like a bank, and avoid to concentrate credit guarantees in a single sub-sector. Risk rating of the different target groups and sectors is recommendable. However, it is possible that, for example from a social perspective, the objectives of a guarantee scheme explicitly require targeting of a specific group through support of a single economic activity. The guarantor should realise that, in this case, costs in the form of loan losses are likely to be higher and some kind of risk premium may have to be charged for this purpose.

Some sectors are less risky than others. Trade and marketing activities are generally at the bottom of the risk chart, while agricultural activities have a relatively high risk of default. Similarly, in a single sub-sector risk may vary according to the degree of organisation of the sector and access to (other) support services. For instance, lending to micro entrepreneurs belonging to producer associations is likely to carry a lower risk than lending to non-associated operators in the same trade.

Management capacity

One of the basic weaknesses of NGOs in micro finance is management.

On the basis of several years of observing NGOs manage guarantee funds, the ILO has drafted a checklist to identify strengths and weaknesses in this field (Annex 1). This can help assess the level of institutional adequacy of a local organization and to identify the areas in which strengthening or restructuring may be needed[2].

[2]For a better understanding of the elements of institutional development of private development organisations involved in small enterprise development, see Edgecomb and Cawley, "The process of Institutional Development", Gemini Working Paper no. 15.

INSTITUTIONAL WEAKNESSES: LESSONS FROM THE ILO-RAFAD COOPERATION ON SELF-MANAGED GUARANTEE FUNDS

1) The *institutional culture of an intermediary* is to a large extent determined by the quality and vision of its leaders. While strong leaders are initially often the determining factor for non-financial institutions to start operations and gain recognition from both donors and beneficiaries, at a later stage the same leaders may obstruct a balanced development of the organisation. By monopolizing decision making and institutional memory, the entire organisation may become dependent on a single individual, thereby making it vulnerable. The development of an organization should be the result of a process of continuous self-evaluation and openness to adjustments and changes. One important pre-requisite for such changes may be the (regular) recruitment of professional staff from outside the organisation.

2) When organisations gradually change from a welfare orientation to a business orientation, there is often a *lack of transparency with respect to the strategy of the organisation*. It will be extremely difficult to operate a credit guarantee programme without well defined financial policies and a clear organisational strategy.

3) Closely related is the effect of an unbalanced growth of services on *the organisational structure*. It is important that the organisation's growth is accompanied by institutional reorganisation and decentralization. The creation of Small Business and Financial Services Departments/Units which operate as autonomous profit centers is likely to enhance management of financial services and the meeting of sustainability targets.

4) The *funding structure*, in particular a high dependence on donor funding, can make these organizations extremely vulnerable. Institutional stability is easily threatened by a sudden withdrawal of important donors. In addition, the “strategy” of a NGO often consists nothing else but a patchwork of project proposals specifically written for donors. A number of steps should be taken to minimize donor dependency: the creation of different sources of income, a donor coordination framework and the reduction of the (relative) weight of each individual donor to a level where withdrawal of funding does not have a critical effect on activities. The establishment of a reserve fund is advisable.

5) Non-financial institutions are generally weak in operational *planning, monitoring and control*. In the absence of annual plans with quantitative and qualitative targets, managers lack the means to monitor and evaluate progress and to take decisions to address possible shortfalls, including staff performance. Due to vague task descriptions and a corresponding lack of incentives to perform, some of the larger NGOs show the signs similar to government bureaucracies.

Programme sustainability

Organizations not specialized in financial intermediation tend to make little effort to become sustainable. The availability of donor funding is one of the major reasons for non-financial institutions to take the issue of cost control and sustainability less seriously. NGOs should introduce appropriate systems of financial planning and cost control. Detailed figures on costs and revenues allow the organisation to make adequate financial projections for capital needs. If subsidization of some sort is necessary figures on the financial status and projections come in handy to convince donors.

SOURCES OF INCOME

Fees and commissions :	Interest revenues
. fees for business analysis	. net interest on fund capi
. application fees	. other interest revenues
. guarantee fees (upon approval)	(f.i. on operating funds)
. service commissions (on top of monthly interest payments)	

3. BANK - NGO RELATIONS: KEY ISSUES FOR GUARANTEE AGREEMENTS

3.1 Information as a prerequisite for transparent negotiations

As banks have little information about the financial needs and savings behaviour of small clients, they find it difficult to assess the credit risk. In turn, NGOs and their clients/members are also generally ill-informed about the way banks operate.

NGOs should know what they are looking for in bank with which they wish to enter into a guarantee contract. This assessment should concern the loan conditions, the physical distance to bank branches, quality and timeliness of services, the autonomy of bank branch managers in the loan approval process and the prospects for a smooth exchange of information on the guaranteed portfolio. These criteria are generally valid. If, in addition, guarantee fund is to be deposited in the bank, it might be advisable to look also at the financial situation of the bank.

Because of their developmental orientation, development banks appear to be most interesting partners, but experience shows that their services are often limited, the branch network is small, and there is always the risk of political interference. Cooperative banks and (municipal) savings banks may be better tuned to provide appropriate small scale financial services.

3.2 What must guarantors offer?

Guarantee funds operated by NGOs have a number of advantages based on their proximity to the clients and their capacity to offer non-financial services complementary to guarantees, like training, counselling and marketing services. The availability of these services is particularly important for a bank, since they are likely to contribute to the viability of the business of the borrower. These services may also produce extra information on the status of the business and possible problems faced by the borrower. This information would allow the bank to act more rapidly, if required.

Risk sharing

A guarantee scheme must effectively allow for a risk-sharing, the precise proportion of which should provide an incentive to the bank to monitor these loans just as normally guarantee loans, i.e. the bank must bear a share of not less than 40% or so; at the same time, the bank’s share cannot be too large either, otherwise there would be no point in getting involved with a guarantee scheme.

CRITERIA TO ASSESS THE SUITABILITY OF BANK PARTNERS

General criteria

. experience with SME lending

. branch network

. special SME department

. branch autonomy in loan approval

. solvency and liquidity situation of the bank

. previous experience with guarantee fund instrument

Service related criteria

. simplicity and rapidity of transactions

. self-financing requirements

. interest rates on loans and deposits

. flexibility towards loan size

. flexibility towards use of credit

. charges to clients

. sanctions potential

. fees charged on guarantee fund-supported loans

. other financial services available (saving facilities)

Reduction of transaction costs

In many countries specialized public guarantee facilities have emerged which go beyond the mere provision of a guarantee and provide other services to encourage bank lending.[3] For banks unfamiliar with the sector of small borrowers, it is extremely difficult and costly to identify potential borrowers and to collect the required information on their financial needs, their business proposals, their collateral situation and their management capabilities. Therefore, it is attractive for a bank if the guarantor also appraises clients, screen business proposals and prepare required information for the loan application.

The guarantor can also assist the bank in loan supervision and follow-up. A review of the lending costs of different types of financial institutions in the Philippines revealed that lender costs related to loan recovery amount to about half of total lending costs.[4] The effect of the guarantor's intermediation may thus result in a considerable cost reduction for the bank.

[3]Doran and Levitsky, 1997; Levitsky and Prasad, 1989.

[4] Balkenhol and Schütte, 1996.

Moral pressure on the borrower

NGOs and especially self-help organisations can exert moral pressure on their members, which helps reduce moral hazard.

3.3 What's in it for the guarantor?

Leverage of financial resources

Guarantees should induce banks to provide leverage, i.e. multiple proportion loan amount/guarantee. Leverage can be a strong argument for NGOs to enter a guarantee arrangement with a bank. There are cases where banks are prepared to release credit up to ten or more times the amount of the guarantee. The higher the leverage, the more the bank's own resources are exposed to risk. It is a good indicator of the progressive appropriation of a market segment by the bank.

WHAT A BANK CAN OFFER A LOCAL ORGANISATION

- leverage of financial resources
- risk-sharing
- loan portfolio administration

The difference with risk-sharing can be seen in the following examples:

UGC, a Mozambique NGO, negotiated a credit line of US$ 280,000 in local currency with the Banco Popular de Desenvolvimento (BPD) on the basis of an international letter of guarantee of US$ 70,000. The agreed multiplier (leverage) was thus 4:1. However, under this agreement the bank did not assume any risk with respect to defaults on guaranteed loans. The first US$ 70,000 in loan losses could be fully called on the letter of guarantee. Any further losses beyond this would be assumed by the bank.

Administrative services

Cash operations and loan portfolio administration require a certain degree of specialization and professionalism. Grassroots organisations like MCCH in Ecuador discovered that through telebanking by modem, their house bank could also provide them with accurate and immediate information on the balances of the MCCH accounts in the provinces.

3.4 Issues to be negotiated

Distribution of tasks and responsibilities

From the start there should be absolute clarity about the distribution of tasks and responsibilities between the parties in a guarantee arrangement.

Pre-loan orientation for (potential) borrowers is generally assumed by the NGO. However, the bank has a clear interest and expertise to be involved in such orientation to ensure that the right information is given. These orientations can be low cost if done simultaneously with other NGO activities.

DISTRIBUTION OF RESPONSIBILITIES BETWEEN BANK AND A LOCAL ORGANISATION AS INTERMEDIATOR AND GUARANTOR	
ACTION	**RESPONSIBILITY**
Pre-loan orientation for small borrowers	Guarantor, possibly with bank
Client identification and selection	Guarantor
Preparation of business plan and loan application	Guarantor
Loan appraisal	Guarantor and bank
Guarantee approval	Guarantor
Loan approval	Guarantor and bank
Loan contracting disbursement and recovery	Bank
Loan supervision and monitoring	Bank and Guarantor
Follow-up on problem loans	Bank and Guarantor
Legal action	Bank, possibly with Guarantor

Client/member identification and selection is normally assumed by the NGO, in light of proximity to and information about the potential bank clients.

Possible assistance in the *preparation of a business plan and loan application* is more of a responsibility of the NGO. Banks should advise the NGO on the kind of information required for loan applications.[5] Procedures and requirements can be rather formal, particularly when guarantees are issued for longer maturity loans and/or for risky target groups such as start-up businesses. The information in business plans and loan applications can vary substantially, depending on the situation. Banks tend to emphasize cash flow analysis, market analysis, while NGOs are often inclined to put more emphasis on the profile of the entrepreneur, such as his/her character and capabilities.

Loan appraisal and approval should be undertaken by both the NGO, as guarantor, and the bank, as lender. The NGO presents a complete file on the client to the bank for appraisal and approval after it has internally *approved* the *guarantee* application and determined the supplementary services it may possibly provide to the client. In other cases, banks and non-financial institutions form joint committees for the appraisal and approval.

Loan contracting, loan disbursement and loan recovery is a responsibility of the bank, often in close coordination with the NGO. The NGO should not interfere in loan disbursement and collection, as this will hamper the development of a normal bank-client relationship.

[5] Annex 4 gives an example of the bank loan application procedures and requirements developed in the context of the ILO Assistance to Business Creation project in Kenya.

Loan supervision and monitoring are done by the bank and the NGO jointly. Information on loan disbursements and repayments should be provided by the bank to the NGO, at least on a monthly basis. Annex 4 gives an example of how such a monthly report may look like. Arrears and defaults need to be defined clearly as well as the conditions and procedures for loan restructuring and for follow-up problem loans.

Follow-up on problem loans should be left as much as possible to the bank. It should be clear to the borrower that the loan contract is with the bank and not with the NGO. In addition, it will be difficult for an NGO to combine the tasks of business counselling with that of enforcing repayment.

These loans might lead to the realization of securities. *Legal action* is costly, particularly vis-à-vis small borrowers but may be necessary to maintain the standard of discipline. Again, the higher the risk shared by the bank, the more it will be concerned about timely follow-up on problem loans. Active monitoring and follow-up by the bank is also important from the perspective of eventual client graduation, as this is one of the means through which banks learn about small borrowers.

In *the realization or execution of securities*, the NGO is usually in a better position to approach the debtor personally and mobilize extra-legal pressure, but it may have limited capacity to take legal action. The bank should have more experience, although it may be reluctant to do so in view of the disproportionately high costs involved.

Bank charges, fees and commissions

For very small borrowers/savers the charges for the opening of savings and current accounts as well as other fees often create an unpleasant surprise. Given the small loan size of the target group, these charges may take unrealistic proportions. This could be negotiated. The NGO will also have to bring forward what it will charge for its services. Certain fees can be directly charged upfront by the NGO. For commissions on the interest rate, it will need the collaboration of the bank. If there are no interest ceilings or other legal restrictions, the bank may be able to charge an additional commission on the interest repayments, which can be subsequently passed on to the NGO. Depending on the bank's involvement and costs related to the scheme, the NGO may try to negotiate a part of the bank's own margin. However, practice shows that this is seldom accepted by banks.

Leverage and risk-sharing

> PRDA, a Sri Lankan NGO, and the Hatton National Bank agreed on a leverage/multiplier of 2:1 and a 50%-50% risk sharing in the context of PRDA’s small prawn farmers guarantee scheme. The international letter of guarantee of US$ 50,000 gave rise to a credit line for US$ 100,000. In this case, each dollar of loan losses would have to be equally shared by the bank and the guarantor, up to an amount of US$ 50,000 for the bank and US$ 50,000 for the guarantor.

Negotiating risk sharing and leverage requires skills and should be based on an excellent understanding of the mechanisms of a guarantee scheme and a good knowledge of the local financial market. It is important to determine the existing risk exposure of the bank prior to negotiations. The extent of coverage should also be clarified, whether outstanding loan principal only or also outstanding interest and bank charges. In the latter case, the maximum number of months should be set for which such costs may be charged by the bank. If a bank does not accurately follow up on arrears, such interest and other bank charges can rapidly accumulate. An annual review of the risk sharing agreement is recommendable. It is important to insist on a minimum level of risk sharing by the bank the first year. In addition, the bank should make a commitment to increase risk-sharing, taking into account portfolio performance.

> The ILO-RAFAD project provided a number of lessons on differences between the multiplier agreed with a bank and the actual leverage effect obtained. In practice, few of the guarantors made full use of the negotiated multiplier, as this requires accurate planning to replace matured loans immediately by new loans requested. This planning, which is part of the overall management of the guaranteed loan portfolio, should be given proper attention. Inflation can also seriously reduce the real multiplier effect. This is the case when the guarantee fund is expressed in hard currency, while the credit ceiling or credit line is expressed in local currency. It is advisable to agree on a multiplier in hard currency terms. If expressed in local currency terms, the multiplier should be renegotiated regularly to offset the effect of inflation.

Conditions and procedures for calling on guarantee

For a bank a guarantee is of high quality if it can be easily called at minimum cost.

Banks often claim guarantees for loans in arrears for more than 90 days. The guarantor should negotiate with the bank, to specify clearly what can be claimed: only outstanding principal, or principal plus accumulated interest due or also other charges, such as penalties. Secondly, a guarantor should satisfy the claim only against evidence of follow-up by the bank between the first date where arrears were registered and the default date. This may entail visits by a loan officer, demand letters to the debtor or co-guarantor or loan restructuring. After the claim has been settled, the bank should continue legal action.

Cooperation agreement

A transparent agreement enhances collaboration and prevents situations which may lead to legal disputes. A written agreement is in the interest of all parties concerned. The agreement should allow for renegotiations.

3.5 Risk sharing instruments

The bank and guarantor can choose from a variety of risk sharing options: international standby letters of guarantee, local guarantee funds and contingency funds.

International standby letters of guarantee: these guarantees, issued by a recognized international bank to the local bank can either take the role of principle guarantee or that of counter-guarantee (a guarantee re-insuring the local guarantees). These international guarantees can be made available by international guarantee institutions, who manage these on behalf of donors or on behalf of non-financial institutions in the South.

> International standby letters of guarantee usually contain the following statement: *".......We, ... (bank name) ......, hereby irrevocably undertake to pay you on first demand, irrespective of the validity and the effects of the above-mentioned facilities and waiving all rights of objection and defense arising therefrom, any amount up to US$ xx , including principal, interest and all other charges upon receipt of your duly signed request for payment ......"*

Local guarantee funds: guarantee funds placed in the collaborating local bank are another option. One part is put in an interest-bearing deposit account, the other serves as a first-call account for claims. Part or all of the fund may be deposited in hard currency with a view of maintaining the real value of the fund.

Contingency funds**:** these are reserve funds or provisions for unforeseen costs, which are often demanded by the local bank, when the principal guarantee consists of an international letter of credit. The contingency fund functions as a first-call account in order to avoid that small claims have to be made on the international guarantee.

In the context of the ILO-RAFAD project, NGOs have used capital reserves fed by up-front provisions. In Peru this was done by means of a monthly commission, but this can also take the form of a one time levy at the time when a loan is issued. In Sri Lanka a contingency fund was created by the beneficiaries of a prawn farmers' guarantee scheme. The members of the association are the owners of the contingency fund.

4. SETTING UP A CREDIT GUARANTEE PROGRAMME

1. ***Assess financial needs***. If the repayment capacity of the target group is very small, then direct NGO lending may be more appropriate, in connection with the retail model. If the financial needs and growth potential of the beneficiaries are more substantial, then the individual credit guarantee model is more suitable.

2. ***Justify the guarantee instrument*****.** The choice for the guarantee instrument is made on the basis of a number of assumptions regarding loan size, maturity, additionality, graduation, leverage, risk-sharing etc.

3. ***Review the local financial sector***. A review of the local financial market should indicate whether financial institutions are interested and suitable for cooperation in a guarantee scheme. Are guarantee schemes already operated? What are the particularities of services provided, the branch network and the overall financial situation?

4. ***Identify of institutional weaknesses and capacity building needs***. Are current operational capacity, its organisational structure and its staff capabilities adequate for running a guarantee scheme? What changes are needed (reorganisation, policy focus, system development, staff training, etc.)?

5. ***Make a financial plan.*** Work out a financial plan on the basis of projections of costs and revenues of the credit guarantee programme. Such a financial plan should contain funding requirements under different scenarios, varying the fund size, utilisation rate, default rates, risk-sharing formulas, leverage, etc.

6. ***Integrate the guarantee instrument into the NGO's business plan***. The Board must agreeto find financial resources for technical assistance, staff training, recruitment of staff, fund capital and operating funds.

7. ***Select a bank and negotiate with it***.

ANNEXES

1. CHECKLIST ON CONDITIONS FOR SUCCESSFUL INTERMEDIATION IN GUARANTEE PROGRAMMES

2. EXAMPLE OF A CO-GUARANTOR AGREEMENT

3. BANK LOAN APPLICATION PROCEDURES AND REQUIREMENTS (EXAMPLE)

4. EXAMPLE OF A SUGGESTED FORMAT FOR (MONTHLY) BANK REPORT TO GUARANTEEING NGO

Annex 1: CHECKLIST ON CONDITIONS FOR SUCCESSFUL INTERMEDIATION IN GUARANTEE PROGRAMMES

	Not relevant	Not satisfactory	Weak	Satisfactory
1. Suitability of the instrument				
The guarantee fund instrument is relevant to the organisation.				
The organisation has prior experience in guarantee funds.				
The organisation has experience in (direct) lending.				
2. Institutional culture and leadership				
The governing body/board is well informed on (the particularities of) the guarantee instrument.				
The executive director/general manager is well informed on (the particularities of) the guarantee instrument.				
The chief of the financial services division/unit is well informed on (the particularities of) the guarantee instrument.				
Financial services are among the priority areas of concern for the organisation.				
There is a consensus at the different management levels about the suitability of the guarantee instrument.				

	Not relevant	Not satisfactory	Weak	Satisfactory
The organisation is willing to commit necessary (financial) resources.				
The organisation is prepared to make necessary organisational changes (reorganisation).				
Board/management are prepared to allocate necessary resources for staff training and the upgrading of monitoring systems.				
Board/management are prepared to recruit professional staff from outside the organisation (if necessary).				
Board/management agree to charge sustainable (commercial) interest rates and commissions to borrowers.				
Members of the organisation consider their leaders representative, capable and transparent.				
Absence of political interference or clientelism which could pose a threat to the guarantee programme.				
Previous financial intermediation has been transparent and professional.				

	Not relevant	Not satisfactory	Weak	Satisfactory
3. Organisational structure				
Financial services are organised in a special division/ unit.				
This division/unit has its own (decentralised) accounts (budget,balance sheet, profit/loss statement).				
Day to day decision making is decentralised.				
4. Strategic and operational planning				
The organisation has a strategic and operational planning capacity.				
The organisation bases its activities on a mid- and long term strategic plan				
The role of financial intermediation in the overall organisational strategy is clear and in coherence with other activities.				
The financial services division/unit has its own annual mid- and long-term plan.				
Financial projections and plans are made on a regular basis.				
The financial service division/unit has its own fund accounting plan.				

	Not relevant	Not satisfactory	Weak	Satisfactory
Annual plans contain clear objectives and targets.				
Targets are regularly reviewed and, if necessary, revised.				
5. Financial policies and procedures				
Policies and procedures have been established for financial services.				
Policies for financial intermediation are transparent and complete.				
Target group and eligibility criteria are determined for each financial service.				
Loan conditions are determined for each financial service.				
The organisation has an explicit policy for the remuneration of financial services and programme sustainability.				
The organisation has an explicit policy regarding delinquency, loan restructuring and legal action.				
The organisation has a clear agreement (policy) for calling on guarantees.				
Adequate procedures are defined in the following areas: - client screening and selection; - loan appraisal and approval;				

	Not relevant	Not satisfactory	Weak	Satisfactory
- loan disbursement and repayment;				
- follow-up on problem loans;				
- calling on guarantees; and				
- guarantee payments.				
Procedures are contained in a user friendly manual;				
Loan/guarantee applications are approved by a special independent committee.				
6. Financial situation				
The organisation disposes of the necessary funds for the guarantee fund programme.				
The organisation has access to outside funding sources required for the programme.				
The organisation disposes of hard currency funds.				
Liquidity of the guarantee fund.				
Solvability of guarantee fund programme in relation to the overall (activities of the) organisation.				

7. Monitoring and control

	Not relevant	Not satisfactory	Weak	Satisfactory
The financial service division/unit disposes of an information system to monitor individual loans and the overall loan portfolio.				
A monitoring system on the status and performance of the guarantee fund is in place.				
Information on loan disbursements and repayments is easily accessible.				
The management disposes of regular (monthly) reports on the status of the finance portfolio.				
Reports contain clear indicators on loans in arrears, in default and the portfolio at risk.				
Regular reports are provided on the status of and calling on the guarantee fund.				
The organisation disposes of an information system to monitor costs and revenues of the finance programme.				
The information system provides information on the workload and performance of each finance officer.				
The management disposes of regular reports on programme performance, programme costs and revenues.				

	Not relevant	Not satisfactory	Weak	Satisfactory
The level of programme sustainability is regularly measured on the basis of (pre-determined) indicators.				
The management provides (semi-)annual reports to the board/governing body.				
The finance programme is subject to regular (annual) external audits.				
8. Staff (management) capabilities				
Relevant managers have the capability to design, update and refine policies, strategies and procedures.				
Programme staff have the required skills to implement necessary activities.				
Managers are capable of making financial projections.				
Relevant staff are familiar with (portfolio) monitoring and reporting.				
Staff are familiar with bank policies and procedures.				
Officers are familiar with the tools to screen business plans on their technical and financial feasibility (including cashflow analysis and market analysis).				
Officers are familiar with tools to assess business management capacities of loan applicants.				
Staff are able to provide pre-loan orientation on (the use of) credit.				

Annex 2: Example of a co-guarantor agreement[6]

I undertake to repay in cash or kind the amount of Ksh. ______________ being part/full amount of the loan granted to ____

(Name of applicant)

by the National Bank of Kenya, Hill Branch, Nairobi, to start a business of

____

(Nature of business)

at ____

(Location of business)

in case of his/her default on loan repayment.

Name: ______________________________________ I.D. N°: __________________________

Nature of work/position: ____

Nature/name of business: ____

Monthly income of guarantor: Ksh. ____

Address/telephone: ____

Relationship: ____

Signature: ________________________________ Date: ____________________________

[6]Tool Kit for Small Enterprise Trainers, Undugu Society of Kenya/ILO ("Assistance to Business Creation" project, Kenya, 1992).

Annex 3: Bank Loan Application Procedures and Requirements (example)

A. Checklist of requirements before acceptance of business plan and loan application by bank

1. Opening of a bank account with the respective branch where the loan is required

   — current account with the xxx Bank of Kenya
   — savings account with xxx Bank of Kenya

   Requirements for opening a bank account:

   — identification card - I.D.
   — 2 copies of passport size picture
   — initial deposit: Ksh. 1,000 for current account
   Ksh. 500 for savings account

2. Letter of application indicating the following:

   — amount of loan and purpose of loan
   — security to be offered
   — terms of repayment

3. Business plan and loan proposal

   — accompanied by relevant pro forma invoices where the loan is required for the purchase of machinery and equipment

4. Security requirements

   The bank will aim to obtain the normal security from borrowers i.e. titled properties, etc. However, it is anticipated that the applicants are unable to provide substantial security thus in such cases the following security can be accepted:

   — chattel mortgage on personal assets and/or business assets owned by the applicant
   — letter of hypothecation on the stocks of the business

   In cases of insufficient or no security to be offered, a letter from a guarantor is accepted.

5. Cash equity

   Cash equity amounting to at least 10% of the total project cost should be deposited to the account.

B. Terms and conditions of loan

1. Required equity contribution - 10% of total project cost
2. Interest rate - 20% + 4% one time fee (commercial interest rate)
3. Bank service charge - Ksh. 100
4. Repayment period - maximum 3 years
5. Grace period - maximum 6 months

6. Frequency of repayment - monthly

C. Requirements before bank loan release

List of requirements to be accomplished before any loan release is made by the bank:

1. chattel mortgage is duly registered;

2. guarantee to the bank is duly registered and applicant is seen by the business advisor;

3. insurance policy is duly completed and annual premium paid;

4. business premises is available and ready for occupancy as evidenced by the lease agreement;

5. license to operate is acquired;

6. machinery, equipment and/or tools to be purchased as per business plan are available and ready for delivery by the respective suppliers as follows:

Machinery, equipment and tools (cheque(s) to be issued as indicated below)	Name of supplier

7. raw materials/supplies needed to operate the project are available;

8. the equity contribution of the client in cash and in kind is available.

______________________________ ______________________________
Business advisor's name Signature

certify for: ______________________________ ______________________________
Name of client Nature of business

____

____
Location of business/Contact address/Telephone

that the above requirements were duly completed.

____
Date

verified by: ______________________________ ______________________________
Loan Guarantee Committee Date

Source: Based on the Tool Kit for Small Enterprise Trainers, Undugu Society/ILO ("Assistance to Business Creation" project), Kenya, 1992.

Annex 4: Suggested format for (monthly) bank report to guaranteeing NGO

NGO: ____________

Bank: ____________ Branch: _______________

Name of client	Sex	Current account number	Nature of business	Loan amount	Balance in loan as of (date)	Arrears as of (date)	Outstanding loan as of (date)	Payment due as of (date)					Payment made in (date)	Arrears as of (date)	Balance in loan a/c as of (date)	Outstanding loan as of (date)	Remarks
								Principal	Interest	Bank charges	Other charges	Total					

Source: ILO's "Assistance to Business Creation" project, Kenya, 1992.

GLOSSARY

Additionality	The effect of a guarantee scheme on bank lending to borrowers who in the absence of the scheme would not have been considered eligible for bank credit .
Arrears	Amount of payments due not received by creditor. Arrears are often classified up to 30 days due, 60 days due or 90 days due.
Chattel Mortgage	A transfer of some legal right to moveable property (home appliances, production equipment, office furniture).
Collateral	Property pledged as security for the satisfaction of a debt.
Counter-guarantee	Promise made by an institution to assume part of the default risk on already guaranteed loans (also re-insurance).
Credit Guarantee Institution	Financial institution extending guarantees to creditors.
Default	Failure to pay loan interest and repay principal due and payable.
First call account	An account which can be immediately debited by a bank when calling a guarantee.
Graduation	The promotion of a borrower from the status of guaranteed bank client to that of regular client (no longer benefitting from a third party credit guarantee).
Guarantee	A promise by a person or institution to make good on a failure by a debtor to pay back a debt.
Letter of guarantee	An authorization by a bank to another bank to draw on its funds, within a stated amount of time and under stated conditions.
Leverage	Credit lines made available by a bank on the basis of a guarantee in excess of the amount of the guarantee.
Multiplier	The factor expressing the proportion between the amount of a

	credit line made available by a bank and the amount of the guarantee.
Re-insurance	Promise made by an institution to assume part of the default risk on already guaranteed loans (also counter-guarantee).
Risk-sharing agreement	An agreement on the sharing of the risk of loan defaults between bank and guarantor.

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LIST OF ABBREVIATIONS

NGO:	Non-Governmental Organisation
PVO:	Private Voluntary Organisation
RAFAD:	Foundation for Research and Application of Alternative Financing for Development
SHO:	Self-Help or member-controlled Organisation
WWB:	Women's World Banking

Enterprise and Cooperative Development Department
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