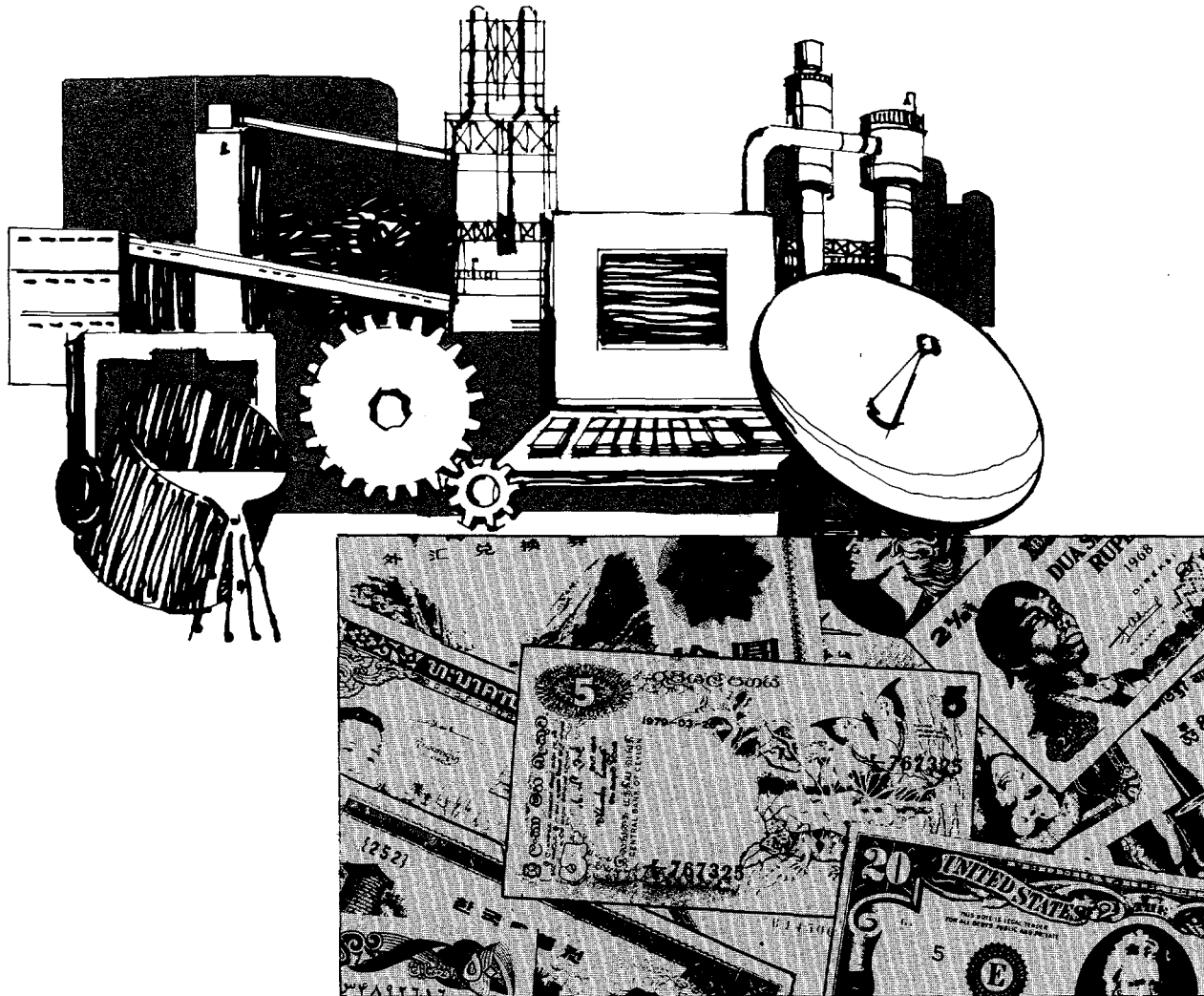


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INDUSTRY AND FINANCE SERIES

Credit Guarantee Schemes for Small and Medium Enterprises

Jacob Levitsky and Ranga N. Prasad



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ABSTRACT

This paper provides information on a variety of credit guarantee schemes in 27 developed and developing countries. Some of the schemes have been in operation for 40 to 50 years, while others have been introduced only in the past few years. Difficulties were encountered in obtaining reliable data on the experience of some of the schemes, particularly the more recent ones, so, regrettably, there are some gaps in the completeness of the data and the periods covered. While the authors make no claim to completeness, it is believed that the information given in the paper will enable the reader to understand the essential elements, scope, and variety of such schemes, and the problems they face in their operations.

The first part of the paper is devoted to a comprehensive review of the issues involved in the design and implementation of credit guarantee schemes, based on the experience accumulated in the countries where such schemes have operated.

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CHAPTER 1

A REVIEW OF THE ISSUES IN THE OPERATION OF CREDIT GUARANTEE SCHEMES

Smaller business enterprises in both industrialized and developing countries have difficulties in obtaining financial assistance from banks and financial institutions. In fact, studies have shown that most small enterprises start their lives without any institutional help. The entrepreneur usually obtains the small amount of finance he needs from his own savings or from his family. However, small enterprises find it difficult to grow without the opportunity to borrow from lending institutions.

The reasons why small enterprises have limited access to institutional finance are well known. They are:

- (1) Lending to small enterprises is considered to be risky. The uncertainties facing small industry, the high mortality rate of such enterprises and their vulnerability to market and economic changes make banks reluctant to deal with them, and there is a parallel reluctance on the part of small-scale enterprises (SSE) to borrow from banks.
- (2) Banks and financial institutions are biased in favor of lending to large corporate borrowers. In some countries there are links between banks and corporate borrowers that take the forms of joint directorships, joint ownerships, and various other joint financial dealings.
- (3) The administrative costs of lending to small enterprises are high and cut deep into the profitability of such loans.
- (4) Small enterprises seeking loans are unable or unwilling to provide accounting records and other documentation required by banks, or to provide securities or collateral for the loans.

In an attempt to overcome some of these problems, particularly the perceived high risks of lending to small enterprises and their inability to provide collateral, credit guarantee schemes have been introduced.

OBJECTIVES OF SCHEMES

Credit guarantee schemes are set up with the purpose of covering some portion of the losses incurred when borrowers default on loans. The purpose of such schemes is to encourage financial institutions, and in particular commercial banks, to lend to small businesses with viable projects and good prospects of success but which are unable to provide adequate collateral or which do not have a suitable record of financial transactions to prove that they are creditworthy. In some cases the

schemes provide guarantees only for loans for investment in fixed assets; in others the schemes guarantee loans for working capital as well. The Canadian and French schemes, for example, specifically exclude guarantees for working capital. The majority of guarantees given in Japan, on the other hand, are for working capital loans. In most industrialized countries, guarantee schemes for loans for fixed assets or for working capital, or both, are the main form of government assistance to the small business sector. Such schemes operate in the United States, Canada, Japan, Australia, New Zealand, and in virtually all the countries of Western Europe.

The basic feature of most guarantee schemes is that the risk of loss is shared in an agreed proportion between the lender and the guarantee organization. Experience indicates that guarantee schemes tend to work best when the guarantees are given for creditworthy clients with good projects who are unable to obtain loans because they cannot satisfy the lender's requirement for collateral. Even in developed countries, guarantee schemes that have attempted to provide guarantees for risky borrowers or risky projects have generally run into problems. All banks are, in effect, guaranteeing against defaults when they make loans as a normal part of their business. It is inherent in banking operations that commercial lenders should be prepared to take such risks and to guarantee their own loans. No amount of collateral or guarantee can, or should, entirely eliminate the risk. In practice, the majority of bank lending is to businesses, organizations, or individuals with whom the institution has already developed a relationship. In this way the risk is reduced to defaults due to unexpected happenings or a general deterioration of the economy. There remains, however, the problem of first-time borrowers, new enterprises, and those borrowers who, for one reason or another, have still to establish a record of creditworthiness.

It is often argued that healthy financial institutions, and particularly commercial banks, should extend a certain amount of unsecured credit—that is, loans without adequate collateral—on the basis of knowledge of, and belief in, a particular borrower's business capacity and economic prospects. In practice, such lending is quite limited. Most financial institutions believe that they must protect themselves in the event that the borrower becomes unable or unwilling to repay the loan. They, therefore, demand securities or the pledging of assets or collateral which may be possessed in the event of default.

Banks face a more complex situation when they make loans that will be repaid over a period of several years. While it may be acceptable to rely on judgements of the character, ability, and financial prospects of a borrower applying for short-term credit, this becomes much more difficult in the case of long-term loans. The uncertainty increases with the length of time for repayment.

In theory, recourse to collateral or other assets provides an element of security to a lending institution that, even in the event of a default, it will not incur serious loss. In practice, however, banks tend to regard collateral chiefly as a means of exerting pressure on the borrower to make maximum efforts to repay. Foreclosing on collateral is a long drawn-out process that often involves costly litigation. In many cases, assets pledged as collateral realize substantially less than estimated, in part because of the time and manner in which they are disposed of. In some countries there are legal problems and restrictions that make the process even more difficult. Generally, it is the hope of lending institutions that recourse to collateral will only have to be used as an ultimate measure and that fear of foreclosure, together with the process of pressure and renegotiation, will lead to repayment. For this reason, banks often reschedule debt payment and make other sorts of financial arrangements rather than foreclose on a loan.

Commercial banks generally like to build long-term relationships with clients and prefer to rely on their own judgements in assessing the creditworthiness of a borrower and his business prospects. They are often reluctant to rely on another organization, even one that is willing to share the risk of default, to interpose itself between the bank and the client. Banks also feel that a borrower who defaults reflects poor judgement on the part of the bank, even if the loan is guaranteed and the actual loss turns out to be low. There have been cases where commercial banks have foregone the right to claim reimbursement from a guarantee fund rather than admit the details of a default, especially when the sum involved was not large.

Some commercial banks who look with disfavor on guarantee schemes claim that, in many cases, those who receive guarantees are often borrowers who would have been able to obtain loans under normal procedures. Even when a guarantee fund is in operation, lending institutions often prefer to obtain pledges of collateral from borrowers rather than relying exclusively on guarantees. Nevertheless, many countries have been attracted to the idea of introducing guarantee schemes in the belief that they encourage commercial lending institutions to be less stringent in demanding collateral and so make them readier to lend to small enterprises.

OPERATION OF SCHEMES

Design of Schemes. A guarantee scheme can work in different ways. Typically, a potential borrower who cannot meet a bank's lending criteria--which usually means the borrower cannot provide satisfactory collateral--is referred by the bank to a credit guarantee organization. In theory, this organization will investigate the borrower's creditworthiness, the use to which the loan is to be put, and his prospective ability to service the debt. If it is found that the case is suitable for a guarantee, the borrower returns to the bank with appropriate certification that he has been accepted for a guarantee. Usually, the guarantee involves the payment of a premium, whose amount depends on the size of the amount being guaranteed.

The above is the general description of the usual process, but in practice there are substantial variations. In particular, schemes differ in the manner in which the tasks of investigation and appraisal are apportioned. Although most schemes, including the more successful ones, provide for independent investigation by the guarantee institution or some independent group, this is often no more than a cursory review. Sometimes, the task is given over entirely to the lending bank, and approval of the guarantee becomes automatic. This seems to be one of the key issues in the operation of guarantee schemes. Clearly, in cases where investigation and appraisal of loan applications are handed over completely to the bank and the guarantee becomes automatic, there is a real danger that the banks will transfer all loans they perceive as risky to the guarantee scheme, even if they have obtained adequate collateral. When this happens, the whole purpose of the scheme is defeated. On the other hand, independent investigation of applications for guarantees, it is claimed, makes the system more bureaucratic, introduces delays, and raises costs.

Experience has shown that each request for a guarantee should be investigated independently, even if the investigation consists mainly of a review of the bank's appraisal of the loan request. It is significant that one of the better known schemes in a developing country, that of the Korean Credit Guarantee Fund, relies heavily on independent appraisal of loan guarantee applications. In fact, there is evidence that in this case, as in some others in developed countries, the banks tend to rely on investigation and approval by the guarantee institution for satisfying themselves that the loan should be approved. But it takes time and a competent staff for a guarantee organization to build up this degree of credibility with commercial banks. It cannot be stated too often that credibility cannot be achieved solely by insisting on formal procedures.

Many schemes in developing countries have placed limits on the size of firms that will be allowed to benefit from the scheme in order to limit guarantees to small enterprises only. Limits are often placed on how much of any single borrower's loan will be guaranteed. The practice of excluding institutions with poor portfolio management and high levels of defaults is sometimes taken a step further through the introduction of a system of accreditation. Lending institutions that have good records on appraisal, loan screening, and debt collection are given accreditation, meaning that their loans are guaranteed automatically. If such a system is introduced, it is important to monitor these institutions continuously.

Risk Sharing. A key issue that arises in designing a guarantee scheme is determining how the risk will be shared between the lending institution and the guarantee fund. Loans in Japan and France are guaranteed 100% in some cases and the bank assumes none of the risk. The more general situation in Europe and some developing countries is to assign between 20 and 50% of the risk to the lending institution. There is some indication that where the risk of the lending institution is 30% or more, the institutions are less interested in guarantee schemes because they must go through the process of appraisal and obtaining collateral to cover their

part of the risk and the costs do not justify adhering to the formalities necessary to obtain a guarantee. In schemes where the risk of the lending institution is lower than 20%, there is a danger that more risky loans are sent for guarantees since the lending institution has little to lose.

Most countries are reluctant to establish a guarantee system where the banks assume no part of the risk. But evidence from such schemes in Japan and France seems to show that such guarantee schemes are more widely used and do not seem to result in excessively high losses. If requests for guarantees are carefully screened and investigated, and the scheme operates in an environment where loan default may seriously affect further business and credit prospects, and where financial institutions may jealously guard their reputation for good judgement, there may be no greater risk in a program that provides a 100% guarantee than one guaranteeing 75% or less. Such is, apparently, the situation in Japan.

Some schemes allow banks to decide what proportion of a loan--up to a specified maximum--will be made at their own risk and what proportion will be lent against the government's guarantee. When a scheme makes it possible to vary the proportion of the risk, most loans tend to be guaranteed to the maximum allowed. To safeguard against abuse, most schemes require banks to bear at least a certain minimum portion of the risk--that is, between 20 and 25%. There are other safeguards as well. In the Netherlands, for example, the government reserves the right to reject a claim and refuse payment against a guarantee if it can show that the bank has not taken all reasonable precautions against default, including a thorough check of the creditworthiness of the applicant. Another type of safeguard is found in the Canadian scheme, which is forbidden by law to provide guarantees for loans for working capital. On the other hand, 85% of all Japanese guarantees are given for working capital loans.

The conditions found in Japan do not generally exist in developing countries. It is important, therefore, to make sure the banks use guarantee schemes prudently, and it is appropriate to require the banks themselves to cover some of the risk. But there is also the problem of making guarantee schemes attractive enough to encourage banks to participate. The evidence collected from most developing countries--and also to some extent from developed countries--indicates that banks are never very enthusiastic about guarantee schemes. They may either lack confidence that their claims will be met if default takes place, or they may fear that satisfaction of their claims will involve considerable delay and costly administrative work. As mentioned above, they also tend to regard any increase in their default rate as an indication of poor banking practice even if the defaults are covered by credit guarantees, and they generally prefer more conservative lending practices. For these reasons, it is necessary to encourage banks to participate in guarantee schemes by reducing their share of the risk. If it is felt that it is desirable to establish safeguards against imprudent use of the scheme by particular institutions, it may be advisable to impose limits on how much of a bank's loans will be eligible for guarantees and to provide that lending institut-

ions which make a disproportionately high level of claims can be excluded. Furthermore, if the claims rate rises unduly there may be a case for raising the proportion of the risk to be covered by the lending bank.

Guarantee Fees. Most guarantee systems require the payment of a fee, or premium, for the guarantee. This fee is assessed in various ways. Sometimes the fee includes payment for the investigation by the guarantee organization along with a 1 or 2% fee to the bank. Some schemes take a one-time payment of 2 to 4% when the loan is arranged, but most schemes prefer an annual premium of between 1 and 2% on the guaranteed portion. At one extreme, one finds situations where no premium or investigation fee is charged. At the other extreme are fees of 4%, which are found in the United Kingdom and Indonesia. When a guarantee scheme was launched in the United Kingdom in 1981, it was believed that the fee (then 3%) would be adequate to cover not only administrative costs but also the payment of all claims. This view soon proved too be over-optimistic.

The argument for imposing a one-time payment for a guarantee is that this insures greater equity--that is, that all borrowers will contribute to the cost of the scheme. In cases where an annual fee or premium is charged on the guaranteed portion, a borrower who repays a long-term loan on time makes a much greater contribution than either an early defaulter or a short-term borrower. Those who favor annual payments, on the other hand, point to the disproportion in the total payments made by short-term borrowers who are charged a one-time front-end fee. A more equitable arrangement might be a small front-end payment and an annual fee on the guaranteed portion.

In a few schemes, such as those in India and in certain Latin America countries, the fee is charged on the total loans, not just the guaranteed portion. The argument used in India was that this made larger borrowers contribute more, thus making the scheme more viable. Such an arrangement makes the guarantee more costly in some cases (e.g., where the guaranteed portion is small) and is feasible only where banks participating in the scheme are required to obtain guarantees for all of their loans.

Annual fees in developing countries usually run about 1%. It is believed that higher fees would discourage banks as well as borrowers, to whom the charge is usually passed on. However, since many schemes, particularly in developing countries, carry low subsidized lending rates, the fee can be absorbed without making the loan unduly expensive to the borrower. A proposal was made in Indonesia in 1983 to raise the front-end premium to 4% from 3%. This would appear to be high, but in light of the subsidized interest rate for small borrowers in Indonesia, and the fact that the Bank of Indonesia and the lending bank absorb most of the fee (they each pay 1.5% of the premium), the 4% rate does not impose a hardship on borrowers.

The fee or premium charged in most schemes is insufficient to cover both administrative costs and claims for default, although, in all schemes, it should be adequate to cover the former. Some schemes have had

very low administrative costs because there has been little or no investigation or review of requests for guarantees; decisions have been based almost entirely on the recommendation of the lending institutions. Low administrative costs may also mean delays in handling claims, with total reliance for debt recovery placed on the lender after the guarantee claim has been settled. There is usually much less incentive for a lending institution to pursue debt recovery after a guarantee claim has been settled, although the lender may be motivated to do so if the institutions own share of the loss for which there is no guarantee is substantial, or if failure to take steps to pursue a defaulter may result in being barred from further participation in the guarantee scheme. Developing countries should not try to cut administrative costs by following such practices. It should be possible to cover administrative costs with an annual fee of 1% on guaranteed amounts. In the United States the Small Business Administration assesses a fee of 0.7% to pay the administrative cost of each guarantee.

In schemes where claims are low the fees may cover claims as well as administrative costs, but when this happens the reason is likely to be an overly conservative appraisal of loans or continuation of demand for collateral, so that the guarantee scheme is not really fulfilling its objective. In some funded schemes, such as that in Korea, returns on investment of accumulated reserves have provided a substantial revenue, particularly in the early period of operation when claims are usually low.

Handling Claims. Experience shows that a guarantee scheme builds up its credibility principally by how claims are handled. A scheme that has the best chance of succeeding is one that clearly lays down regulations on when a claim will be paid. A commitment on the part of a guarantee organization to settle claims quickly also helps its credibility. The regulations should specify the period of arrears after which the guarantee may be invoked and what specific steps the lending institution is required to take to satisfy the guarantee organization that it has made efforts to obtain repayment. Once a guarantee has been approved, responsibility rests with the guarantee organization, and the question of whether the lending institution processed the loan application with due care can only be reopened if there is clear evidence of misrepresentation when the loan documents were submitted. Even then, if confidence in the scheme is to be maintained, the review should be after payment has been made against the claim. In settling claims the guarantee organization should reserve the right to reopen the case if further information is forthcoming indicating gross negligence or misrepresentation when the guarantee was requested or in collecting the debt.

Every guarantee scheme must be operated efficiently to deal quickly with claims. Excessive red tape and delays in payment act as major deterrents to the readiness of lending institutions to participate in guarantee schemes.

All schemes should lay out an agreed process for recovering from the borrower whatever can be recovered towards repayment of a loan, even

after settlement of a claim. In some schemes this task is imposed on the lending institution; in other cases the guarantee organization has this responsibility. Questions have sometimes been raised as to whether lenders are likely to proceed vigorously against debtors once they have been reimbursed. It should be remembered, however, that guarantee funds usually reimburse lending institutions for only part of the loss. Furthermore, most guarantee schemes only guarantee the loan principal and do not include reimbursement of lost interest. A lender will ordinarily incur some loss on the unguaranteed part of the loan and usually on all, or part, of the unpaid interest. This should, in most cases, stimulate the lender to recover whatever amount it can from the defaulter. A guarantee organization can, and should, take steps to exclude lending institutions that do not live up to their obligations to seek recovery of debts. It should also be understood that invoking a guarantee is a last resort, and that every attempt should be made to obtain repayment, either through loan reheduling or through other means. Sometimes, however, the question arises of whether to proceed against a defaulter where the unpaid portion of the loan is small and the loss incurred by the lender is insignificant. In practice, such situations are rare. Maintaining good credit relations with the bank usually acts as a potent motivation to a borrower to repay the last part of a loan or to reach some agreement on rescheduling repayment. Nevertheless, circumstances do arise where decisions have to be made as to whether the costs of proceeding against a defaulter are justified in light of the small amount involved.

Giving the guarantee organization the task of recovering losses can only be effective if the guarantee organization is strong enough to take on the task. Usually, lending institutions will have more means for carrying out this task. As the operations of the Small Business Administration in the United States show, debt collection can be a heavy administrative burden.

All repayments, amounts recovered, and losses incurred should be divided between the lending and guarantee institutions in proportion to their degree of risk on the original loan. The question of how recovered amounts will be shared needs to be spelled out carefully. Some schemes recognize that the lending institution should be compensated for lost interest and for legitimate expenses involved in debt recovery. To encourage lenders to vigorously pursue willful defaulters, some schemes are generous in allowing the lending institutions to make prior claims on the amounts recovered.

Financing of Schemes. Schemes should be designed with the intention that the fees and other incomes (e.g., return on investments) will cover all costs arising from both administration of the schemes and from claims. It has been suggested that a guarantee scheme can be treated statistically or actuarially in the manner used by insurance firms to set the appropriate premiums. Such statistical analysis could also help to determine the appropriate relationship between the resources available (i.e., amount in a guarantee fund) and the amount of guarantees that could

reasonably be given out. It might also provide valuable information for setting the level of the guarantee fee if it is so that the fee (along with return on capital invested) should cover costs due to claims paid out as well as administrative expenses.

Unfortunately, credit guarantees or credit insurance cannot be equated with other insurance operations. One needs at least ten years' records on loan repayment behavior under similar conditions to reach any valid statistical conclusions. Experience in developed countries shows that loan defaults (and payout of guarantee claims) vary significantly depending on economic conditions and the quality of evaluations. In a difficult business environment with high unemployment, defaults are usually higher. Higher interest rates increase loan defaults, while lower interest rates increase early repayments. It is virtually impossible to take into account all the factors in any statistical projection of what loss rates might be.

Nevertheless, some statistical projections are possible and desirable. Using an estimated loan loss rate (which could be a rate determined as an acceptable objective based on available data) the cost of administering the scheme, the extent of risk sharing and the guarantee fee or premium could be set, as could the total amounts of guarantees that could be given for different levels of the guarantee fund. Changes could then be introduced to take account of any changed pattern revealed by later data. If defaults were higher than estimated, a decision could be made to increase the size of the guarantee fund (either by raising fees or other means), or to limit the total amount of guarantees. Some such statistical monitoring of a guarantee scheme is essential for effective management. Account would have to be taken of the discounted value of loss amounts and investment income accruing from reserve guarantee funds. Such revenues are not available to a non-funded guarantee scheme.

Many schemes in both developed and developing countries are funded by governments and the amount of guarantees should be related to the size of the fund. The total amount of guarantees may be limited, as in Canada, by legislation, or the limit on the amount of the guarantees may be specified as a multiple of the resources available in the guarantee fund. In general, there seems to be a tendency in advanced countries to permit guarantees up to a sum of 20-25 times the amount in the fund. In some cases, however, the limit may be more than 30 times the size of the fund; it is 36 times the fund size in Germany. In other cases the multiple is lower than 20. In Barbados the limit was 10 times the sum in the fund. In Chile a scheme was operating in 1984-85 which only permitted guarantees equal to the total resources in the fund. This was later deemed to be overly conservative, and the total amount that could be guaranteed was set at five times the amount in the fund. After some years of operation, well-run schemes in developed countries with claims rate of 2 to 4% are able to give out guarantees for 20 to 25 times the amount in the reserve fund without undue risk. In the early stages of a guarantee scheme in a developing country, when loans are being made to smaller and less

established borrowers, guarantees up to 10 times the amount in the fund would seem to be reasonable. Lending of less than 10 times the amount in the guarantee fund raises the question of whether the guarantee scheme serves any real purpose in increasing the access of small enterprises to institutional finance. It is better to combine a higher leverage rate with a higher fee to make the fund financially viable rather than to keep the fee low and structure the fund conservatively.

If claims increase unduly, steps must be taken either to reduce the guarantee volume or to increase the amount in the guarantee fund, and also to increase the fee. As an indication of the conservatism of some schemes, one may cite the guarantee fund in Cameroon--one of the few operating in Africa--which was permitted to guarantee up to seven times the amount in the fund but after five years of operation had only given guarantees of up to 1.6 times the fund. Such risk aversion on the part of guarantee organizations soon becomes a major factor in producing a reluctance on the part of the banks to using the scheme.

There are many other ways in which guarantee schemes can be financed. In the Philippines, for example, the resources of the Industrial Guarantee Loan Fund (IGLF) come directly from the central bank of the country (along with some international financial inputs), which provides finance for the loans and covers the guarantees from the same fund. Schemes in the Federal Republic of Germany and Japan are funded through local or regional credit guarantee associations. These credit guarantee associations pay the claims against defaults from a fund financed by contributions from financial institutions, local authorities, trade associations, chambers of commerce, and state, regional, or national treasuries. In Japan there is a double guarantee system. The guarantees given by credit guarantee associations are then insured up to two-thirds by the state-financed Small Business Credit Insurance Corporation.

The credit guarantee scheme in the Republic of Korea is funded primarily by a levy on the profits of all banking institutions eligible to participate in the fund. Efforts have been made in some developing countries, to finance guarantees schemes through levies on commercial banks, as in the case of Rwanda, where a guarantee scheme--so far inactive--has been financed in this way. German institutions have contributed to a guarantee fund in Peru and are working to create an international guarantee fund based in Switzerland which would reguarantee (or reinsure) guarantees of schemes in developing countries, mainly in Latin America. Some schemes are unfunded--that is, there is no specific guarantee fund, merely a pledge by the government to cover the guarantee on any loan on which there is a default. One of the oldest credit guarantee schemes, that of the Netherlands, operates in this way. Claims are met directly from the government budget. "Unfunded" schemes, which also operate in the United States and Canada, simplify the operation of the scheme in that the government simply assumes financial responsibility for the operation and meets claims out of revenues. In developing countries, however, it would be advisable not to adopt such an arrangement but rather

to establish a fund from which claims are settled. The lack of such a fund in Morocco caused a major crisis in the scheme there. Furthermore, lack of a fund deprives the guarantee organization of revenues obtained from investing the organization's reserves.

The credit guarantee schemes operated in the United States by the Small Business Administration through the commercial financial system have the interesting feature that the banks are permitted to discount a portion of the guaranteed loans in the secondary money market. This means they can sell the loan applications in secondary markets as government-backed securities. In this way, capital is released for further lending. Since these loan obligations are usually bought by insurance companies and pension funds, the guarantee scheme provides a means for channeling funds from large financial institutions to small businesses.

ASSESSMENT OF GUARANTEE SCHEMES

Scope and Impact. It is worth noting that the proportion of all bank loans which are subject to guarantees in all countries is small. In France, 11.3% of all medium- and long-term loans raised by French companies of all sizes carry a guarantee. In Japan, where one million new guaranteed loans are made annually, nearly 5% of all lending to small firms is covered by the guarantee system. In other countries it is lower, often less than 1%. In Germany there is concern that there is not wide enough use of guarantee schemes. The NMB (Nederlandische Middenstand Bank), the principal bank that provides guaranteed loans for small firms, and originally the only bank operating such a scheme in the Netherlands, stated early in 1983 that only 0.5% of its long-term lending was covered by guarantees. Despite the low percentage of lending covered by such guarantees, the sums sometimes have represented a significant increase in the amounts available for business start-ups by individuals who lacked collateral and any record of creditworthiness. These schemes have been particularly helpful in providing long-term lending to small business.

Additionality of Lending. For guarantee schemes to meet their objectives, it must be shown to have created additional lending to the finance that would normally be made available by the banking system to the small business sector. This will occur not only if loans are made without any collateral but also if collateral requirements are lowered. It is, in fact, desirable that lending institutions avail themselves of whatever collateral borrowers can provide since this will ultimately ease loan recoveries. But it has proved difficult to show whether, in fact, any guarantee scheme has resulted in additional credit for small business.

A scheme introduced in 1981 in the United Kingdom was an attempt to ensure additionality but has operated merely with bank declarations that loans would not have been made without the existing guarantees. Other schemes try to insure that banks are not passing on to the guarantee scheme what would be acceptable risks for the lender. This is usually done by having requests for guarantees reviewed by a body independent of the banks

responsible for the appraisal decision. In the Netherlands, attempts are made to go even further by stating that "payment will be withheld under the guarantee scheme if an investigation reveals that there was acceptable security for a normal bank loan at the time the guarantee was granted." The U.S. Small Business Administration requires evidence that normal bank loans are not available to the borrower before it gives a guarantee.

In virtually all countries where credit guarantee schemes exist, there are those who claim that banks shift riskier loans away from their normal lending to the schemes. Such a danger exists in all schemes, but a greater problem in developing countries seems to be how to get commercial banks to participate in the program and to be less risk-averse in their lending to small firms. Also, there is a great mistrust in developing countries of all publicly-supported schemes. Many commercial banks in developing countries express disbelief that guarantee schemes supported by the government will meet claims if the number of claims begins to increase. In some countries where this has been true, commercial banks have refused to continue to participate in the schemes. The passing on of risky loans to guarantee schemes seems therefore to be a major problem only in developed countries. In developing countries a bigger problem is how to convince commercial banks to participate in the schemes.

Creating Confidence. It cannot be stressed too often that the operation of guarantee schemes involves resource costs. If a scheme is to achieve its objective, some risks must be taken and some borrowers will default. Some claims will then have to be paid, with minimum bureaucratic complications. It is also essential that the rules and regulations are clearly spelled out so that there are no arguments about whose responsibility it is to pursue defaults, about when claims can be made, and about the conditions under which the guarantee will not be paid.

A debt will not normally be fully recoverable from the realization of whatever assets, collateral, or guarantees are available after a default. It is therefore necessary to specify clearly how amounts recovered will be apportioned. There are also administrative costs in the appraisal of guarantee applications, in the processing of claims, and in pursuing debt recovery. Again, it is important to state clearly how these costs will be met. If attempts are made to lower administrative costs unduly, there is a danger that the scheme will be inadequately supervised and that there will be long delays in paying claims. Successful schemes, mostly in developed countries, have shown that payment of claims is carried out without undue delay when procedures are suitably designed and effectively implemented. Efforts to recover from defaulters also benefit from suitable design and good implementation.

Loss Rates. An accurate indication of the loss rate will only emerge after five or more years of operation. The loss rate on most of the schemes that have been in existence for some time, at least in developed countries, is not unduly high. In Japan, where the mortality rate of small business is considered high, the loss rate is just over 2%. The loss rate

is defined as total claims for default paid out as a percentage of loans guaranteed. In Canada the loss rate in 1981 was only 0.6%, but it was substantially higher in the United States. Internal studies by the Small Business Administration have found that, on a discounted basis, the total costs of the SBA's guarantee program were 8.3% of the original guaranteed amounts. This cost included a statistical projection of future losses based on past records. Other interesting findings were that the "purchase" of loan guarantees (i.e., the invoking of guarantees) peaked in the second year of loan repayment, and that there were significant differences in loan default rates in different regions of the U.S. The first report on the United Kingdom scheme suggests a relatively high loss rate--probably above 5%.

The loss rate, to some extent, is a function of policy--namely, the policy on how far to extend the "risk frontier." In general, it can be said that the "risk frontier" has been enlarged in the United States to make finance available to minority groups, first-time borrowers, firms hit by natural disasters, and others who are being encouraged to start businesses. In some other countries the guarantee scheme has a lower loss rate because other programs with much higher default rates are available. These include the special minority business program in the U.S, the subordinated loan program in the Netherlands, and the credit program of the Federal Business Development Bank in Canada (FBDB), which operates as a last resort public financial institution.^{1/} If other schemes to deal with more risky ventures are maintained, loss rates can be kept low, but there is always the danger that excessive-concern over the loss rate may defeat the very purpose for which the scheme was originally designed. Finally, there is the question of the total cost of operating a scheme. Most schemes in developed countries have relatively modest costs that represent only a small part of the total costs of all support programs for small business.

CONCLUSION

Credit guarantee schemes appear to be an attractive form of support for small enterprise development in developing countries, where non-availability of finance has been a serious constraint in developing the small business sector. However, guarantee schemes only have meaning to the extent that the commercial banking system is ready to participate in the scheme. Schemes in which the only participants are publicly-funded development finance institutions have little meaning, since ultimately the losses of these institutions must be made good from the public treasury. The evidence from developed countries is that the government, the business community, and the banking system must all assume some part of the risk. Credit guarantee schemes cannot and should not completely absolve banks from taking a normal level of risk as such risk-taking is acceptable banking practice. Similarly, credit guarantee schemes should not be expected to provide finance for projects of doubtful viability. Credit guarantees backed by public funds should not eliminate the need for the lender where possible, to obtain some form of personal guarantee or collateral.

^{1/} FBDB had a loss rate of 2.1% in 1981 against 0.58% of the Small Business Loan Act (SBLA).

Finally, credit guarantee schemes should be launched only when it is recognized by all concerned—and specifically the guarantee organization that the scheme will entail costs. The guarantee organization must accept that it is entering into contracts on which payments will have to be paid. Guarantee schemes should be monitored constantly and changes made when necessary in the proportion of risks, participation, premiums, etc. These changes, of course, should apply only to future commitments as any attempt to change the rules on guarantees already approved would seriously undermine confidence in the scheme.

Mutual Guarantee Associations. All that has been written so far refers to publicly funded guarantee schemes, including some which are partially financed from fees or other payments from banks or associations. There are certain limited guarantee schemes which operate more like mutual guarantee associations or cooperatives. In these schemes a number of enterprises make payments to a cooperative or association which will then be prepared to guarantee loans taken out by any member, up to certain amounts. Such arrangements have worked reasonably well in both developed and developing countries among farmers, artisans, and tradesmen. Their impact on the total volume of lending to small enterprises is very small, but this does not mean that such initiatives are not worthy of support.

Independence of Guarantee Organization. Summing up, it can be stated that guarantee schemes can represent an important financial instrument available to compensate for market imperfections which may result in the small business community being deprived of access to institutional finance. As a financial instrument which can play an important role in redistributing credit, a guarantee scheme, and the organization that operates it, should aim at self sufficiency and financial independence over the course of time. The fund will need to be capitalized adequately to meet its obligation particularly over the first years of its operation. The scheme should be designed with a financial plan which should set down the capital needed for the guarantee fund and the estimated level of claims expected to be paid out. This should determine the total amount of guarantees that can be undertaken at the projected level of claims, and of the fund available. This provides the basis for setting the fees, in light of other revenues available and the administrative costs needed to achieve the estimated level of operations.

If managed efficiently, with a realistic level of fees and revenues from investments, and if operated with a business approach and assuming only prudent risks, guarantee schemes should be able to achieve financial autonomy while fulfilling its main purpose in assisting small and medium enterprises to obtain the finance they need for their development.

PART I

SCHEMES IN OPERATION IN DEVELOPED COUNTRIES

CHAPTER 2

NORTH AMERICA

UNITED STATES

Section 7(a) of the Small Business Act, introduced in 1968, empowered the Small Business Administration (SBA) to guarantee loans made by participating lending institutions to eligible small businesses. The objective of this program was to assist independent small business concerns in the United States by increasing the institutional finance available to them by reducing the risk of financial institutions that made loans to small businesses. A blanket guarantee agreement between the participating bank and the SBA covers all loans guaranteed by the bank (except line-of-credit loans with maturities of one year or less) and specifies the terms under which the bank and the SBA will cooperate to issue and administer these loans.

Eligibility. Loans are eligible for guarantees under this program only if other methods of financing are unavailable on reasonable terms and the loans are expected to be of sound value or so secured as reasonably to assure repayment. The loans may be used for a variety of business purposes, including expansion or relocation, construction, machinery and equipment, working capital, etc. The applicant is expected to be able to document the likelihood of a cash flow of at least one-and-a-half times the amount of debt service. Applicants are also expected to make a substantial capital commitment themselves. Equity to debt ratios of 1:1 are normally required, although in some cases ratios as low as 1:4 are accepted. Borrowers must have an unquestionable credit reputation and records showing several years of profitable performance. New ventures do not normally qualify, nor do ventures with inexperienced management. In order to qualify, a firm should not employ more than 500 to 1,500 persons, depending on the industry. Guarantees for business loans have a maximum maturity of 25 years, while guarantees for working capital loans are generally limited to seven years.

Risk Sharing. The scheme guarantees up to 90% of the loan amount. In theory, 90% is supposed to be the maximum guaranteed portion, but in practice it is virtually the norm for all guaranteed loans. The total amount guaranteed cannot exceed \$500,000 per borrower.

Guarantee Fee. In return for the guarantee, an initial fee of 1% of the guaranteed amount is collected by the SBA from the lender when the loan is disbursed. This fee may be transferable to the borrower. The program's interest rates have been only slightly higher than normal bank lending rates and have generally been lower than interbusiness and other sources of financing. Regulated rates have varied from 1/2% over prime to 2-1/4% over prime for loans of less than seven years and 2-3/4% over prime for loans longer than seven years.

Claims Procedure. Lenders are required to notify the SBA of the status of each loan on a quarterly reporting form provided by SBA. If non-payment of a guaranteed loan persists for 60 days after the due date, the lender may demand that the SBA "purchase" the guaranteed portion of the outstanding loan balance, including any accumulated interest. It is at

this time that funds are paid by the SBA to the lender. The amount paid is the guaranteed portion of the principal, plus interest, to the date of loan "purchase." Usually, the SBA then proceeds to take over servicing of the loan. From that point on, future payments by the borrower are made directly to SBA. Occasionally the SBA will purchase the guaranteed portion of a loan while the bank agrees to continue administering the loan. When a loan is in default and remedial actions have been unsuccessful, the SBA and the lender may agree to initiate liquidation proceedings. The SBA or lender proceeds with liquidation, which either results in the loan being paid in full or the remaining loan balance being written off. The guaranteed portion of the outstanding unpaid balance is considered a loss to the SBA.

Operation of the Scheme. The SBA loan guarantee program has been relatively successful in inducing commercial banks to lend funds to small businesses. Annual loans approved rose from \$385 million in 1969 to \$1.9 billion in 1973, then declined somewhat before rising to \$2.7 billion in 1977 and to \$3.4 billion in 1980. However, by 1983, annual loans approved fell to \$2.5 billion. The total number of loans disbursed rose from 6,240 in 1969 to 24,106 in 1980 before dropping to 17,053 in 1983. The total amount actually disbursed to small borrowers in 1983 was \$1.8 billion. As of September 1983 there were 81,473 loans outstanding totaling \$7.1 billion. The total number of banks certified under the scheme was 580 as of 1983. These operations were supported by an SBA staff of around 2,000 persons in Washington, D.C., and in 10 regional and about 100 branch offices.

The SBA thus appears to be reaching a small but significant share of what is defined as small business in the United States. A detailed breakdown of loans approved in 1983 is given in Table 2-1.

Table 2-1. SBA LOANS APPROVED IN 1983

Category	No. Loans	% of Total Loans	Amount (US\$ million)	% of Total Amount
Retail	5548	36.1	733.8	29.8
Services	3957	25.7	558.7	22.7
Manufacturing	2262	14.7	498.9	20.2
Wholesale	1617	10.5	324.6	13.2
Construction	727	4.7	121.5	4.9
Transportation	454	3.0	92.3	3.7
Agriculture	472	3.1	78.7	3.1
Finance	160	1.0	24.8	1.0
Mining	61	0.4	14.5	0.6
Other	128	0.8	17.6	0.7
TOTAL	15,386	100.0	2,465.4	100.0

Evaluation of the Scheme. Although there are approximately 14 million business establishments in the United States, only 5 million of these had gross receipts of more than \$25,000, and only 2 million had gross receipts of between \$100,000 and \$1,000,000. It is not known if all SBA-guaranteed loans go to businesses that would not otherwise receive bank finance. Each time they make a guaranteed loan, banks do certify that the loan would not be made without such a guarantee. SBA regulations and review procedures appear adequate to prevent the substitution of guaranteed loans for other modes of finance. Finally, and most persuasively, the additionality of these loans is suggested by an average default record greatly in excess of the general average for commercial banks (net losses in guaranteed loans of 4.95% in 1983, versus less than 0.5% of all loans).

The SBA program is also a success in the sense that the guaranteed loans are term loans, with 80% ranging from 5 to 10 years. Term loans are not readily available to U.S. small businesses from other sources, although they are commonly associated with expansion or improvements in productivity. Although term lending has become a common practice among U.S. commercial banks, lending especially for small enterprises is usually for periods of less than five years.

Finally, the program has been a success from the point of view of offering a relatively high guarantee rate--that is, up to 90%, at the lender's option. Compensation or repurchase of defaulted portions of guaranteed loans has been nearly automatic, with investigation normally occurring after rather than prior to compensation.

The SBA loan guarantee program has been criticized on several accounts. From the taxpayers point of view its prime deficiency is the large subsidy required to support the administrative costs and losses of the program. Some observers question whether the guaranteed lending is sufficiently selective in view of the 12.9% ultimate loss rate (the sum of net losses plus projected losses) and the 4.95% loss rate of 1983. In addition to net losses not covered by the guarantee fee, annual administrative costs average about 0.7% of the portfolio outstanding.

From the borrower's and the lender's points of view, the initial required procedures have involved excessive paper-work and delay. Thus, a pilot program was instituted in 1978 to test the transfer of responsibilities for loan evaluation and for the liquidation of defaulted loans to accredited banks. It was expected that the time required for an accredited bank to receive SBA approval on a loan would be reduced from around 20 days to 3 days. Some banks reported in the early 1980s that approval required 6 to 10 days. It was also hoped that transferring responsibility for collection and liquidation would reduce the net loss rate and total administrative costs. It is not certain, however, that banks will be willing to take over these responsibilities unless they are compensated. Compensation formulas have yet to be worked out, however. In the past, banks have been allocated 3/8% of outstanding balances when they have been asked to administer recovery on defaulted loans.

Small business leaders have frequently complained that SBA guaranteed loan procedures were complex and rigid, and that loan standards were too conservative. Since the average loan is approximately \$160,000, the program is clearly not directed at the 12 million business establishments with gross sales below \$100,000, but rather at the 2 million with gross sales between \$100,000 and \$1 million. The upper limit for some types of firms, such as wholesalers, is gross sales of \$10 to \$20 million, although no loan guarantee may exceed \$500,000. In practice, loan guarantees have not benefitted firms that can provide very little collateral, although minimum collateral requirements of 75% are moderate. Banks are free to establish higher collateral requirements, and normally require the pledging of all available assets. Whether banks lower their normal collateral requirements in the case of guaranteed loans is not known, but the recovery ratio of only 30% on defaulted loans suggests that such requirements have been lowered. It also appears, however, that borrowers without any collateral would not be granted guaranteed loans.

Conclusions. The SBA loan guaranteed programs should be judged in light of the U.S. environment before any attempt is made to adapt it to developing countries. The SBA program has four fundamental advantages not often found in developing countries. Reliable nationwide credit rating services allow low-cost verification of applicants' credit standing. Most applicants have reliable accounting and other records that make it possible to judge their past performance quickly. Most commercial banks have staff with experience in evaluating term loans on the basis of projected performance. And there are enough small business in the United States to interest commercial banks in meeting their financial needs.

Other advantages are the relative ease and moderate degree of loss with which collateral may be liquidated, and the relatively low cost and expediency with which legal procedures can be used to protect the lender's legitimate interests or recover defaulted loans. The great amount of low-cost information on conducting all types of small businesses also differentiates the situation in the United States from that in developing countries. Since the coming to power of the Reagan administration in 1981, efforts have been made to abolish the SBA and to eliminate the loan guarantee program but so far the strong reaction to these moves from the business community have prevented this being carried out.

CANADA

Guarantees for lending to small enterprises were initiated in Canada under the Small Business Loan Act (SBLA) of 1961. The objective of the Act was to encourage lenders in the private sector to make term loans available to small businesses. The Act was originally limited to a period of three years but has been extended from time to time. To qualify for a guarantee, loans must meet certain criteria specified in the legislation. These relate, among others things, to the maximum amount of security to be taken, the maximum rate of interest to be charged, the maximum term of the loan, the purposes for which loans may be made, and the persons eligible to receive them. A number of changes have been made in the legislation since 1961.

Eligibility. All small businesses engaged in manufacturing, trade, services, construction, and transportation are eligible, but guarantees are given only on loans for fixed investment, which includes purchase or construction of premises and purchase of land for factory construction. The regulations specifically exclude all forms of working capital. In 1977 a small business was defined as one with annual revenues of less than C\$1,500,000. Borrowers were required to provide equity of at least 20 percent of the total cost of any project or 10 percent of the cost of purchase of land or the construction or purchase of premises. All credit assessments are made by the lending institution.

Participation in Scheme. Under the original Act, all chartered (commercial) Canadian banks are designated as lenders. The Act was later amended to include credit unions, caisse populaires, and trust, insurance, and finance companies.

Guarantee Fee. There is no charge for the guarantee, either to the lender or to the borrower but the maximum interest rate permitted to a lender is 1% over the prime rate.

Risk Sharing. Approved loans are guaranteed to 90% by the government, the other 10% being at the lender's risk. The maximum loan size was increased from C\$75,000 to C\$100,000 in 1980. The Canadian scheme has a special feature in that it imposes a global ceiling on outstanding guarantees and also a limit on the amount guaranteed for loans to any single institution. In 1981 the global ceiling was C\$1.5 billion.

Funding of the Scheme. The loan guarantee system in Canada is unfunded. The arrangement is centralized, and the national government meets deficiency payments from budgetary resources.

Operation of the Scheme. From inception of the program to the end of 1982, 117,343 guarantees had been given for loans totalling C\$2,415 million. In 1982 alone, a total of 17,044 guarantees for loans amounting to C\$440 million was given. The annual report of the guarantee program for 1982 states that there was a marginal decrease in the number of guaranteed loans compared to the previous year and the dollar values of loans made decreased by 14.9%. The average loan in 1982 was C\$25,837.

Up to the end of 1982, a sum of C\$28.14 million was paid on 1,880 defaulted loans. Recoveries from defaulters came to only C\$367,211. The loss rate on the scheme was estimated at about 0.58% for 1980.

The number of participating lenders stood at over 1,350 by the end of 1982 (not including the new Schedule B banks chartered under the revised Bank Act). Service businesses were the leading group of borrowers in 1982, accounting for 42.2% of all loans, followed by retail establishments (24.7%), transportation (10.1%), manufacturing (10.0%), and construction (8.6%).

Evaluation of the Scheme. The guarantee scheme under the Act and direct lending by the Federal Business Development Bank (FBDB) are the main types of Canadian government support for small business. The FBDB grew out of an Industrial Development Bank set up in 1944 and renamed and restructured in 1975. The FBDB's role is to provide long-term finance to small firms that cannot obtain funds on reasonable terms elsewhere. The FBDB has 103 branches to carry out its lending. It is government-owned but operates outside the Small Business Loan Act.

A study was carried out during 1981 to assess the effectiveness of the FBDB and the SBLA, and whether these programs provided a net benefit to the country. The report concluded that while the FBDB "expanded the pool of financing available to small business, particularly those that are marginal or start up enterprises, the SBLA (guarantee scheme) seems to have duplicated, in large part, the term-lending facilities already available at the chartered banks...." The report found that bankers had mixed attitudes toward SBLA guaranteed loans and the effectiveness of the program. The report goes on to say that "Most bankers have granted very few SBLA loans and have argued that high risk lending is imprudent...the banks' regular lending programs are more than adequate to finance small business' needs." Some bankers doubted whether the scheme had added to the volume of bank loans to marginal small business; others thought that some banks were lending under SBLA to businesses that could have obtained loans through normal channels. The bankers also claimed that SBLA loans were going to creditworthy clients, who were thereby in a strong position to demand the lower SBLA interest rate. Sometimes, the report adds, SBLA guarantee loans were offered to potential customers to attract them away from a competitor.

The study concludes that the FBDB was more successful in making financing available to small businesses than the SBLA. However, the FBDB had a loan loss ratio of 2.10% for 1980 (high by Canadian standards), as against 0.58% for SBLA loans. The average ratio of loan losses to all loans outstanding, both to large and small firms, for the five largest chartered banks was 0.40%.

CHAPTER 3

EUROPE

FRANCE

Loan guarantees in France are of two kinds, one for medium-term loans and the other for long-term loans.

Guarantees for Medium-Term Loans

Medium-term "Article 8" bank loans, which are generally refinancable by the central bank, can be guaranteed either by one of the 15 regional development societies (SDRs, or Societes de Developpment Regionale) or by one of the 59 or so mutual guarantee organizations (OCMs, or Organisation de Credit Mutuel), which are sectoral bodies. The SDRs are private institutions (though with public law status and special borrowing privileges) whose shares are listed on regional exchanges. Both SDRs and OCMs are under the control of a government body, the Credit d'Equipement des Petites et Moyenne Enterprises (CEPME), which was formed in 1980 to merge the functions of three previous organizations. CEPME provides a second rank guarantee to lending banks.

Additionality does not seem to be a specific aim of the French system. Also, the scheme has not been restricted to small enterprises (PME--Petites et Moyennes Enterprises). Subsidiaries of large firms have been able to take advantage of Article 8 loans, particularly through the SDR.

Eligibility. The credit appraisal for a guarantee is done by a committee of the SDR or OCM, on the basis of a dossier prepared by the bank, but final approval by CEPME is required. The latter's role is to make sure that the loans qualify under refinancing rules, which require them to be for specific equipment or fixtures. Working capital is excluded. OCMs and SDRs are able to approve guarantees for loans of less than F 0.5 million on delegated authority, with CEPME examining the applications after the fact.

The OCM credit committee is appointed by the sectoral trade associations and would normally include directors of firms. This sometimes leads to problems of conflict of interest when an application from a friend or a competitor is being considered. Similar problems arise on SDR committees, which include local businessmen. On the other hand, trade or local knowledge has proved useful in appraisals. A CEPME representative also sits on the credit committees.

Guarantee Fee. The OCMs and SDRs charge borrowers a flat fee of 1-2% which is reimbursable at the end of the loan, plus a running commission of 1.2% per annum on the outstanding balance, half of which is passed to CEPME. Guaranteed loans, not subject to any of the numerous interest subsidy schemes, carry a rate that is 1-2% below commercial levels. Banks have an additional incentive to use the guarantee system since half of their guaranteed loans are excluded from the total used to calculate solvency margins being transferred to CEPME's account.

Risk Sharing. In theory, the guarantee is for 100% of the loan, but in many cases (and particularly for smaller loans) the banks provide a counter-guarantee of 50% to the OCM or SDR. Borrowers have to provide security, where available, and a personal guarantee. The loan amount is limited to 70% of the asset cost, and the loan term must correspond with an agreed depreciation schedule. The SDRs and OCMs' total guarantee obligations are limited to various multiples of their funds.

Claims Procedure. When a default occurs, the claims procedure is favorable to the banks in that they receive reimbursement of the whole loan as soon as a payment is missed, even when they have given a counter-guarantee. CEPME is responsible for debt recovery.

When a default occurs, the bank's first claim is on the funds of the OCM or SDR. Only when these are exhausted does the CEPME guarantee to the bank operate. Some SDRs' rules allow them to supplement their guarantee funds from their other resources, up to 20% of the fund. However, the OCMs' funds are limited to their retained earnings from commissions and the returns from investing the funds. There have been times when OCM funds were exhausted by claims, but they can recommence operations by building a new fund. There has been considerable rationalization among OCMs in recent years, with mergers creating more powerful organizations. In certain weaker sectors, including textiles, shoes, and furniture, OCM funds have been supplemented by government allocations from sales tax revenues.

Operation of the Scheme. Up to now, the medium-term system has been self-financing from the government point of view. CEPME and its predecessor, Caisse Nationale des Marches de l'Etat, have been in surplus on their guarantee business and have paid dividends to the state. Deteriorating economic conditions in the early 1980s strained resources, however, particularly since many of the OCMs had to draw on funds accumulated over many decades to meet claims. It appears that the banks now bear most of the cost of the loan guarantee scheme.

The scheme is widely used. In the years 1979 to 1981, about 35,000 new guarantees were given annually. In 1981 the new commitments amounted to F 8.6 billion, and the total outstanding at the end of that year was F 420.1 billion. These figures include a small proportion of guarantees given under certain special programmes, including energy conservation, technical innovation, and export development. In all, Article 8 guaranteed loans accounted for 11.3% of all funds raised by French companies of all sizes on the medium and long-term capital market.

On a much smaller scale, two government-supported Fonds Nationale de Garantie administered by CEPME provide support to the subordinated loan program and to the creation of new enterprises. These funds have only been operating since 1980. In 1981 the two funds provided guarantees, respectively, for 300 loans amounting to F 358 million, and for 50 loans amounting to F 30 million. The new enterprise fund is used mainly by the SDRs.

Guarantees for Long-Term Loans

Guarantees for long-term loans are given by the SDRs. These loans are for terms of between 5 and 15 years, whereas Article 8 loans range from 2-1/2 to 7 years. The loans themselves are also made by the SDRs, using funds raised through public bond issues. SDRs apparently receive a government subvention equivalent to a spread of 2% on this program. A condition of obtaining a loan of this type is participation in a borrowers mutual guarantee fund.

Borrowers of long-term loans pay a flat fee of between 3 and 5% of their loan into the fund. These fees are then invested and claims are met first from investment returns, then from retained fees, and finally from SDR reserves. The fee is refundable from the eighth year of the loan onwards, less that proportion which has been allocated to meeting claims. At the liquidation of loans of 12 years or more, accumulated interest is also paid. The SDR long-term loan program had F 17 billion in outstanding loans at the end of 1981 and provided F 2.8 billion in new lending in that year. The authoritative Mayoux report (1979) described the program as a crucial mechanism for institutional investment of long-term funds in small businesses.

Up-to-date data on loss rates were not available as of late 1983, but an estimate given in 1978 suggested that, on average, borrowers lost about half their guarantee fee.

Problems of division of responsibility between banks and guarantee institutions do not arise in this scheme, since only the SDRs are involved. Additionality is also less relevant because a major aim is to provide long-term money without requiring personal guarantees. Presumably, some borrowers would have been willing and able to give sufficient personal guarantees to banks in return for cheaper loans.

The loan guarantee system in France is well integrated into the institutional and policy framework for the small business sector.

FEDERAL REPUBLIC OF GERMANY

Credit guarantees in the Federal Republic of Germany are provided under a decentralized institutional framework which reflects both the federal political structure and the main economic divisions of Handwerk (skill-intensive manufacturing, repair and service trades), Handel (distribution), and Industrie (larger scale manufacturing).

The operation of the credit guarantee system varies from Land (region) to Land, but the basic principles are common throughout the Federal Republic. Guarantees are given by 34 locally based private credit guarantee associations (usually called Kreditgemeinschaften, or KGa's) to commercial, savings and cooperative banks on medium and long-term loans. KGa's are limited companies established by the business community as mutual assistance organizations. Chambers of commerce, trade associations, banks, insurance companies, and other private sector organizations contributed the initial capital and are represented on KGa boards. Additionality of lending was the express purpose of the KGa's, and this purpose is built into the appraisal procedure. Each KGa has a credit committee composed of chamber of commerce, banking, and government representatives which decides on applications for guarantees prepared by banks. The KGa staff usually makes direct contact with the borrower to assist in the appraisal. Often, a guaranteed loan is in addition to other loans.

Eligibility. Small firms in all sectors are eligible to receive guaranteed loans. Equity percentage requirements usually stipulate a minimum of 20% after the new loans are included. These requirements were enforced more rigorously after 1980 because of recession. Further safeguards are personal guarantees from borrowers and any available security on second-rank business assets not acceptable for normal bank lending. In the case of new businesses, the chamber of commerce for Handwerk or Handel must provide an independent and positive recommendation which covers both an assessment of the entrepreneur's capability and a market analysis of his project. The entrepreneur must be qualified in his trade before being allowed to start his own firm.

Guarantee Fee. Small businessmen applying for guaranteed loans, are charged an application fee of DM100. The fee is refunded if the guarantee is granted. A non-refundable flat fee of 0.5% of the amount guaranteed is also charged to the borrower, in addition to the normal 2% bank arrangement fee. Despite these charges, the screening process is so thorough that both the banks and the KGa's claim that they do not recover their full costs. This fact is given as one explanation for the limited demand from banks for KGa guarantees. Borrowers apply for the guarantees through the banks. The weak demand, in turn, explains why the interest rates charged on guaranteed but otherwise unsubsidized loans are not significantly below normal market rates. The borrower also pays a running fee of about 0.25% quarterly on the diminishing balance of the guaranteed amount.

Risk Sharing. The amount of the guarantee varies from 50 to 90% of the loan; the average is 75%. Counter-guarantees are provided in a ratio of 3:2 by the Federal and Land governments covering 60% of the guaranteed amount, and a further 12.5% is covered by the European Recovery Programme guarantee fund administered by the government-owned bank, Kreditanstalt für Wiederaufbau (KfW). Hence, the KGa's are responsible for only 27.5% of the risk on the guarantees themselves.

Funding of the Scheme. Funding for the scheme consists of capital subscribed by KGa shareholders, accumulated reserves, and borrowings from the European Recovery Programme at a special interest rate of 5.5%. These borrowings are restricted to between one-third and one-half of the total fund. The KGa's fund is invested, and the return on this provides the major source of income. The volume of guarantees is theoretically limited on the supply side by regulations on the KGa's. In recent times they have been allowed to guarantee up to 36 times their funds, the former multiple being 18. Generally, however, the regulations limiting KGa commitments do not in reality constrain the system.

Claims Procedure. Banks are obliged to inform KGa's that a borrower has failed to meet a capital repayment. A decision to treat a loan as in default appears to be a joint one between the bank and the KGa.

When a borrower in difficulties wishes to extend the term of his loan, permission must be given by the bank, by the KGa, and by the government counter-guarantors. When a default occurs, it is the bank that is responsible for recovery. The KGa normally reimburses the bank only at the end of the recovery process, although sometimes (to save accumulating interest costs) the expected final deficiency is paid over fairly quickly, and a time limit is set for the realization of security and personal assets. The KGa keeps watch over this. For example, KGa staff attend auction sales to ensure that the bank is acting in the KGa's best interests. The bank also has to demonstrate that the credit was used for its intended purpose before the deficiency payment will be approved.

Some KGa's allow banks the option of first call on assets taken as security for guaranteed loan, in return for which capital repayments are allocated first to the guaranteed portion of the loan. Otherwise, the capital repayments and recoveries from security are allocated according to the risk-bearing proportions.

Operation of the Scheme. The total amount guaranteed by the KGa's and still outstanding at the end of 1978 was DM 1.2 billion (US\$450 million). On average, about 3,000 new commitments are made every year, amounting to about DM 300 million (US\$115 million). This represents a very small proportion (less than 0.5%) of loans to the whole of the Mittelstand (small and medium-sized business sector). Even for Handwerk the proportion is probably only 1%. Loss rates have been low, but rose a little in the early 1980s. From the inception of the KGa's in the 1950s to the end of 1978, there had been 1,100 guarantee deficiencies totaling DM 31 million, representing 1.9% of the total number of guarantees and 0.9% of their total value. However, the figures for the five years 1977 to 1981 were an

average 120 defaults a year and average annual losses of DM 8.5 million. In the Handel (distribution) sector, the deficiencies of at least one KGa in 1980 would have prevented any new commitments in 1981 had the shareholders not subscribed new capital.

The costs of the system in Germany appear to be borne mainly by the government, which effectively subscribes to 72.5% of the losses and also subsidizes the administrative costs of some KGa's through Land budgets. The banking sector carries very little of the burden, its main contribution being occasional capital inputs to the KGa's. Borrowers pay only a little more, overall, for guaranteed loans.

Evaluation of the Scheme. Generally, the credit guarantee system in Germany should be regarded as a way of putting moral pressure on larger economic and financial institutions to play a part in helping the Mittelstand (SME). The KGa's themselves, however, are widely regarded as being both overcautious and bureaucratic. The banks, which are responsible for 25% of the risk, consider guaranteed loans to be high-risk ventures, and they dislike the high costs they incur in participating in the scheme.

ITALY

There are three loan guarantee systems in Italy--one for the artisan sector, another for the agricultural sector, and a third for the small industry sector.

Artisan Scheme

The artisan scheme has been operated since 1964 by the Artisan Cassa, a public body that provides a channel for various government programs to the sector, the most notable being a substantial interest rate subsidy. The guarantee operation is supported by a central guarantee fund which was established with a capital grant from the government.

Eligibility. Small enterprises with less than 15 employees are permitted to participate in the artisan scheme. Appraisals of loan guarantee applications are carried out by local credit committees operated by branches of the Artisan Cassa. Additionality is an objective of the scheme and is investigated as part of the appraisal. Prospective borrowers normally have to provide their bank with a personal guarantee.

Guarantee Fee. The charge to borrowers is a one-time flat fee of 0.5% of the loan amount.

Risk Sharing. Loans are guaranteed up to 70% of the loan amount.

Funding of the Scheme. The central guarantee fund receives additional revenue through an allocation of the subscription income paid by member firms of the Artisan Cassa and is also subsidized by central government subventions. Although full figures are not available, it appears that the major source of fund revenues is the central government subventions and that guarantee fees are not intended to cover losses.

Claims Procedure. When a default occurs, the fund reimburses the bank promptly and then acquires rights to any security and personal subrogation. In the case of a bankruptcy, the courts realize assets on behalf of the fund. Otherwise the fund's own staff carries out this function. If the bank waives a repayment, it loses its right to make a claim under the fund's guarantee. Generally, however, the bank decides when a loan is to be treated as in default.

The Small Industry Scheme

A completely different system is in operation for the small industry sector. There are approximately 80 mutual consortia funds, one or more for each province in Italy. These are private bodies, but they are subject to general statute law governing the activities of consortia. On average, 150 local enterprises constitute a consortium. Each enterprise guarantees a sum of Lit 1 million (US\$560 approximately in 1984) and thereby acquires a consortium guarantee on a loan from a bank with which the consortium has an arrangement.

Guarantee Fee. A borrowing firm pays an annual fee of between 0.5 and 1.0% on the outstanding balance of its loan to the consortium.

Risk Sharing. The percentage guaranteed and the limit of the guarantee sum are decided case by case by the board of the consortium. This board normally has representation from the local branch of the national small industry organization, from the local chamber of commerce and similar bodies, and from member firms. On average, guarantees are given for 50% of loan amounts.

Funding of the Scheme. The scheme is funded by accumulated fees and commitments from consortium members. The consortium's obligations cannot exceed the sum of its liquid resources. Each consortium has its own constitution limiting individual loan guarantee obligations. The consortium may be able to call upon its members to increase their guarantee amounts if it wishes to increase its obligations. In the event of a default, the consortium has recourse first to its liquid assets (usually invested in local bank deposits) and then may call on members for additional commitments.

Operation of the Scheme. The number of loan consortia rose from 39 in 1971 to about 1,980 in 1982. The system is widely used and there have apparently been no spectacular failures. Banks are often anxious to be chosen to work with the local consortium. In 1977, the most recent year for which data were available, the total volume of outstanding guarantees was Lit 216 billion (around US\$200 million then).

The loan consortia have begun to offer management consultant services to their members. In general, the mutual nature of the consortia, and their freedom from political interference, suit Italian businessmen very well.

NETHERLANDS

A loan guarantee scheme has existed in the Netherlands for more than 40 years. Under this scheme, loans granted to small and medium-sized businesses are guaranteed by the Ministry of Economic Affairs. Until 1977 only one bank, the Nederlandsche Middenstand Bank (NMB), had the prerogative of granting loans under the scheme, but since then the scheme has been extended to a group of ten banks. Even after 1977 the NMB retained about 70% of the guaranteed loans market. The next largest participant is the Union of Cooperative Banks (RABO).

Eligibility. Small and medium-sized enterprises in commerce, manufacturing, crafts, and services are eligible to receive guarantees. An enterprise is classified as a small or medium-sized enterprise if the number of employees does not exceed 100 people, and, in the case of an industrial enterprise, if sales do not exceed f. 7.5 to f. 10 million (\$2.5 to \$3.3 million in 1985).

Appraisal of a guarantee application is thorough. An application from a new business must be accompanied by a recommendation from the Dutch small firm agency (CIMK) or the government advisory body (RND). This often causes delay, since neither organization is under pressure to produce reports on prospective borrowers quickly. All borrowers must have a relevant trade qualification certificate. The application screening includes a check on the history of any previous applications to any participating bank. An important criterion for the appraisal committee is the overall gearing of the business. Guaranteed loans are appraised by reference to the whole business and are not linked to a specific project or equipment purchase. The equity percentage required varies from 5 to 30% of the total net assets after the loan, though the requirement tends towards the higher percentage. Independent valuations are made of equity assets where appropriate.

Additionality in the Netherlands is achieved mainly through the screening process, under which the banks are effectively subject to government control. For guarantee commitments above f. 300 thousand (about \$100,000), approval must be obtained from the guarantee department at the relevant Ministry. For smaller commitments, from NMB, the department has a representative on its internal credit committee who can veto a loan by insisting that it be referred to the full department. Other banks jointly fund the operation of a single credit appraisal committee consisting of representatives of small firm organizations, accountants, retired bankers, and a government nominee who again has the power of veto through mandatory referral. One principle applied in the appraisal of guarantee applications is that the Bank should have obtained all available collateral before applying for a guarantee.

Guarantee Fee. No guarantee fee is charged to the borrower. As in some other countries, it was expected that market forces would drive down interest rates on guaranteed loans, but in practice the reduction was

marginal, (about 0.25%). The reason given for this was that credit controls are generally fairly restrictive in the Netherlands. But according to the NMB, guaranteed loans are excluded when the bank's solvency margins are calculated. A more plausible explanation is that there has been a good deal of cooperation between the participating banks, for example, and that competitive relationships have yet to develop.

Risk Sharing. The design of the scheme is very simple. A special department of the Ministry of Economic Affairs guarantees loans made by NMB and the other participating banks to 100% in the case of general business loans, including subordinated loans, and up to 47% of loans secured by a mortgage on business premises.

The guarantee takes the form of a "deficiency guarantee." That is, the government will indemnify the banks for any net loss they suffer as a result of a default on a guaranteed loan, once all recoveries from security and personal guarantees have been taken into account. The scheme reimburses loss of interest to the date of indemnification. Personal guarantees given to the bank are a standard requirement, as are any available security in the form of second-rank business assets (e.g., furniture and fittings). The government payments are known as "declarations."

Funding of the Scheme. The Credit Guarantee Scheme in the Netherlands is unfunded. The government has an open-ended budget commitment to cover liabilities arising from claims.

Claims Procedure. Another control on additionality is provided through the claims procedure. Before a "declaration" is accepted, the guarantee department at the Ministry reviews the history of the loan. The department can, and occasionally does, exercise its right to withhold acceptance if the review shows that the rules of the scheme were not observed by the lending bank.

From the government's viewpoint, the default procedure has several problems. One is that because the bank continues to earn interest on the loan while it is realizing on collateral, there is sometimes insufficient pressure on them to foreclose on loans quickly, and to the maximum extent. This applies particularly where the unguaranteed lending portion is small.

One approach to this problem being considered is to agree on a time limit for the realization of security. In principle, the banks are obliged to pursue the recovery of any outstanding debt for five years after their claim has been satisfied by a "declaration" payment.

Another problem is that there is an administrative backlog in approving "declarations." The staff of the department numbers 17. Additional staff might achieve savings if "declarations" could be approved more quickly, thereby reducing interest charges.

Operation of the Scheme. The proportion of lending to small and medium business that is guaranteed is roughly estimated at about 5%. Outstanding commitments amounted to f. 1242 million (US\$415 million) at the end of 1981. There were about 9,300 outstanding loans under guarantee at the end of 1980. About 3% of all retail businesses had a guarantee loan at that date.

Recent data (to 1983) indicate a sharp increase in the amount of claims paid. Declarations rose from f. 6.3 million in 1978 to f. 43.4 million in 1981, and the trend in 1982-83 was still upward. This represents a rise in the loss rate from less than 1% to about 4%.

A particular problem in the Netherlands has been the sharp fall in property prices after 1980, which substantially reduced the security on many loans and resulted in higher losses. By early 1983 there was serious concern on how to modify the system to reduce the cost to the government. Various possibilities that were being considered included increasing the equity percentage required and asking the banks to bear some of the risk on non-mortgage loans.

A different problem has arisen in cases where the NMB has used its own authority to grant new small guaranteed loans to an existing borrower, thus reducing its own exposure by effectively refinancing at the government's risk. Since 1981 the banks have also tended to reduce the percentage of building values on which they will accept a mortgage. This leaves the government to pick up a correspondingly higher percentage under its business loan guarantee window. Although restricted to guaranteeing 40% of the bank's mortgage under the building loan guarantee window, the government in principle will guarantee a loan on the unmortgaged portion of the building value under its business loan scheme. To deal with this, the government has begun to require banks to take a first mortgage (instead of the usual second-rank mortgage) to cover their exposure. Practices like these, however, tend to nullify the purpose of the guarantee scheme.

PORTUGAL

After the revolution of 1974, far-reaching changes took place in the Portuguese economy which compelled the government to save small enterprises in danger of collapse. An Institute for Small and Medium Enterprises (IAPMEI) was created in 1975 in the Central Bank and was given responsibility for the operation of a guarantee scheme. Most of the loans guaranteed were short-term and for working capital, mainly to enable firms to purchase raw materials or to finance confirmed orders.

Eligibility. Short-term loans which prefinanced confirmed orders or financed the purchase of raw materials, and long-term loans which financed fixed and working capital investment, or expenditures incurred in restructuring operations, are eligible to receive guarantees.

Risk Sharing. For short-term loans the maximum guarantee in 1980 was Esc 1.5 million (US\$33,000 equivalent at that time) or 50% of the loan, whichever was less. For long-term loans the maximum guarantee was Esc 5 million (US\$100,000 equivalent in 1978) except in cases of mergers, joint ventures, or projects located on industrial estates, where the ceiling can be raised.

Funding of the Scheme. IAPMEI was given control of a guarantee fund of 2 million contos (then about US\$60 million).

Claims Procedure. The Guarantee Fund provides that in the event of default the creditor may request IAPMEI to pay the percentage of the amount in arrears equivalent to the percentage of the guarantee. Unless it can arrange a rescheduling, IAPMEI will honor the guarantee. The agency and the creditor must then initiate court proceedings against the firm in default.

Operation of the Scheme. As of June 30, 1978, IAPMEI had guaranteed 555 loans totalling Esc 510 million under the short-term facility with the total amount guaranteed equalling Esc 291 million (Esc 154 million outstanding). Of loans granted up to June 30, 1978, 46 loans (9%) had defaulted, and IAPMEI had to pay Esc 27 million (9.3% of the total amount guaranteed) to the lenders. During the same period IAPMEI had provided guarantees for 435 long-term loans amounting to a total of Esc 1,205 million, with the total amount guaranteed by IAPMEI equalling Esc 562 million (Esc 484 million outstanding). Defaults of loans granted up to June 30, 1978, numbered 10 (3%), and IAPMEI had to pay Esc 16 million (2.8% of the total amount guaranteed) to the banks.

Evaluation of the Scheme. The Guarantee Fund proved to be the most important financial service offered by IAPMEI in the early years of its operation. After 1979, however, the IAPMEI started acting as a promotional agency for lines of credit available to small and medium industry (SMI) from the World Bank and other international institutions, and the Guarantee Fund declined in importance. Commercial banks that

onlent the lines of credit preferred to take collateral for the loans they made. IAPMEI continued to offer guarantees from the Fund in cases where the collateral offered was insufficient, but such guarantees were provided only in a limited number of cases and in smaller amounts after 1980. In retrospect, however, it can be said that the Guarantee Fund played an important role in rehabilitating the small and medium industry sector after the changes of the mid-1970s in Portugal.

UNITED KINGDOM

The United Kingdom's Loan Guarantee Scheme was introduced in June 1981. The scheme is administered directly by the small firms division of the Department of Industry in London, using a staff of 2-3 people. Thirty financial institutions were participating in the scheme in early 1983, including the "Big Four" clearing banks. Applications for guarantees are made through the banks, which carry out the screening and appraisal of loan applications. One of the objectives of the UK scheme, and an objective not found in other countries, was to end the usual requirement of personal guarantees from small businesses seeking bank finance.

Eligibility. The decision to give a guarantee is formally the responsibility of the small firms division. Applications forwarded by banks have to be accompanied by a declaration that the loan is additional, in the narrow sense that without the scheme the bank would not have offered finance on the same terms to the small firm. With this declaration, and as long as the application meets the criteria laid down as to the business sectors to be included and the size and term of the loan, approval is automatic. The maximum amount (there is no minimum) which can be borrowed is £75,000. Loan terms range from two to seven years, and applicants must be prepared to pledge all available assets.

Guarantee Fee. In return for a guarantee, the borrower originally was required to pay a premium of 3% of the guaranteed amount, quarterly in advance, on the outstanding balance. This premium was designed to make the U.K. scheme self-financing. But the failure rate has proved greater than anticipated, and as a result it was decided early in 1984 to raise the guarantee fee to 3.5%. In addition to the guarantee fee, borrowers in most cases have to pay the bank a 1% arrangement fee. Initially, the interest rates on guaranteed loans were no lower than those on unguaranteed loans to small firms, in most cases 2.5% over base. In July 1982, however, one of the banks reduced its rate on these loans by 0.5%. Early acceptance of the scheme was far greater than anticipated, and it seems that the banks recognized the scheme as providing them with a relatively risk-free and profitable market. After reports appeared on high failure rates, the premium was raised to 4% in 1985 and subsequently in April 1986 lowered to 2.5%. The proportion of the guarantee was also reduced from 80% to 70% of the loans. Interest in the scheme dropped appreciably when the premium was raised to 4% and the proportion guaranteed reduced.

Risk Sharing. The scheme provided for a guarantee cover of 80% of the loan but, as stated, in early 1984, this was reduced to 70%. Since the maximum amount which can be borrowed is £75,000, the maximum claim liability per borrower after 1984 was £52,500. The exclusion of personal guarantees applies both to the guaranteed portion and to the portion on which the bank bears the risk. It was thought that this would be sufficient to prevent unsound loans. In many cases, however, personal assets (usually houses) were used to obtain secured overdraft finance for the business along with a guaranteed loan. Under these circumstances, the proportion of total bank lending at risk is of course smaller than 30%.

Claims Procedure. The Banks have discretion in deciding when a claimable default has occurred. Their claims are met automatically within 14 days, and they are then obliged to cover as agents what is available from the realization of any security and forward the appropriate share (80% or 70%) to the small firms division. Although formally the guarantee applies only to the loan principal, in practice banks have in some cases been reimbursed for a proportion of one quarter's interest loss.

Operation of the Scheme. By mid-1986, 16,500 guarantee commitments had been made on loans totalling £530 million, an average of £32,000 per loan. About half of these were for new businesses. The scheme was originally designed to be self-financing, but the government admitted in 1983 that claims for the previous financial year were expected to exceed premiums by around £8 million. Outside estimates of the failure rate have varied from one in five to one in 20,^{2/} it being argued that early experience was not typical. A major source of equity and loan capital for small and medium enterprises, the Industrial and Commercial Finance Corporation (ICFC), points out that one in three of the new businesses which it backs fails within the first five years.

An assessment of success in terms of additionality is difficult to measure. Counting loans to businesses which could have raised alternative finance by giving personal guarantees as additional, the government's preliminary review of the scheme found that only 60% of the loans sampled (both in number and value) were in fact additional. A further 20% could have obtained bank finance if the borrower had given personal guarantees. The remaining 20% could only have been financed by non-bank finance, which would have been more expensive and therefore less attractive to the borrower.

Evaluation of the Scheme. At the time the scheme was introduced there was criticism that the 3% guarantee fee was too high since the banks were also charging a standard 1% arrangement fee in most cases. The 3% premium, though generally higher than most of the schemes studied in this report, is not unreasonable if the aim is to cover the total cost of the scheme. No other funding or revenue sources were provided to meet claims, and the loans guaranteed are essentially unsecured, so that there is little offset from recovery of security. Only unencumbered business assets not considered adequate for security against a normal bank loan can be used. However, the problem appears to be that the banks are not actually lowering interest rates to compensate for the additional burden of the guarantee fee, as had been hoped would be a result of relieving the bank of a substantial part of the risk on loans. The subsequent lowering of the premium in 1986 to 2.5% after raising it to 4% in 1985 seems to indicate that there was a recognition that a 4% premium was too high and a deterrent to use of the scheme.

^{2/} A later report (April 1984) stated the failure rate appeared to be as high as one in three in the early period of operation of the scheme but one in five seems to be the accepted figure after three years of operation.

The banks were accused of not screening applications with sufficient care and of using the scheme to provide finance for firms in difficulties. A review of the scheme was carried out in 1983 by a firm of accountants, who reported on the first 50 cases where the borrower defaulted on the loan and the guarantee was called. The accountants also tried to establish whether there had been a shift from ordinary bank lending to lending under the scheme, and whether the screening procedures had been adequate.

The 1983-84 review drew attention to the increasing use of the scheme as a "topping up" facility in a package of structured finance (equity, term loans, and overdraft). It observed that "capital gearing (the proportion of loans to equity) and, in particular income gearing or debt servicing ratio (the amount of net income taken up in repaying loans and interest) were astonishingly high in a very large number of the failures which we studied." The review also seemed to indicate that many borrowers were inexperienced.

Some other interesting facts that emerged from the above report were that the average loan size was then £33,000 that 60% of loans were obtained by new enterprises, and that around 50 to 60% of the loans could be classified as additional, based on the indicator that the borrower had been refused normal bank financing. The report also stated that the loans were mainly used for working capital. This may help to explain the finding that jobs were being created at the remarkably low cost of around £1,350 each.

CHAPTER 4

ASIA AND THE PACIFIC

JAPAN

The credit guarantee system in Japan has existed for about 50 years and is widely used by small firms. The institutional arrangements are quite complex. There are 52 local Public-law Credit Guarantee Corporations (CGC) which provide guarantees to banks lending to small firms. The banks in turn reinsure 70-80% of their commitments with the Small Business Credit Insurance Corporation (SBCIC). The entrepreneur seeking a guaranteed credit usually approaches his bank but may apply directly to the CGC, which will then refer him to a suitable financial source. The loan application is generally appraised by the CGC, and if collateral is required the CGC will handle the details of this as well. Appraisals are thorough, often involving personal visits. Because the guarantee applications are screened and the decision to approve an application is made by the credit guarantee corporations who are at risk, the loans tend to be sound. About 5% of the applications are rejected.

Eligibility. Enterprises with less than 300 employees in manufacturing, less than 100 in wholesale distribution, and less than 50 in retailing are eligible for guarantees. Separate arrangements exist for farming, fishing, and forestry. The great majority of guaranteed loans require the borrower to give his personal guarantee to the bank. Collateral is also required in more than half of the cases, although it is generally secondary business collateral (stock, for example).

Guarantee Fee. The borrowers pay an annual guarantee fee of 1%, of which 0.37% is passed on by the guarantee corporations to the (SBCIC) as a reinsurance premium. The banks, competing for risk-free business, have driven the interest rate down by about 0.9 percentage points, significantly reducing their spread. They tend to use the scheme only where they cannot make a loan otherwise.

Funding. CGCs receive contributions from local government and local financial institutions, and they receive low interest loans from the national government via the SBCIC. There is a ceiling on the total obligations which can be assumed by each CGC. This ceiling is a multiple of reserve assets. The system is inherently resilient to higher loss rates, since the liquidity of the CGCs is underpinned by substantial borrowings from central and local government. At the end of 1981 the total borrowings amounted to approximately nine times the net payments in subrogation for that year.

Risk Sharing. The Credit Guarantee Corporations provide 100% guarantees to the banks. The CGCs in turn reinsure 70-80% of their commitments with the Credit Insurance Corporation. Therefore, the CGCs bear 20-30% of the risk, while the remaining 70-80% risk is borne by the SBCIC. The banks bear no risk.

Claims Procedure. If a repayment is missed there is generally a "cooling-off" period before the CGC actually makes its payment in subrogation, during which time the borrower has extra time to make the repayment

(interest continues to accrue, however). In the case of a single missed installment payment, the presence of the guarantee is usually sufficient to allow the bank to carry the missed repayment until the end of the loan period. For a single repayment loan, up to 90 days may be granted before subrogation is called for by the bank. The CGC offers management advice where it has become a creditor to small firms through subrogation payments. A contractual relationship between the CGC and the borrower appears to arise only after the former has indemnified the bank and acquired its rights over security and guarantee in subrogation. Recoveries are pursued vigorously, and the borrower may well continue to pay off his outstanding debt from his salary in the years following his bankruptcy. The CGC first tries to realize the collateral; if this proves impossible, it will finally claim the personal guarantee. When losses cannot be fully recovered, 70 or 80% of the loss is borne by the Small Business Credit Insurance Corporation and 20-30% by the CGC.

Operation of the Scheme. Since 1974, approximately a million new loan guarantee commitments have been made annually. The amount outstanding reached ¥7 trillion, or about US\$30 billion, at the end of 1981. This is about 5% of all lending to small and medium-sized businesses. The widespread use of credit guarantees in Japan is primarily due to the system's decentralized operation. All the 52 CGCs have strong links, formal and informal, with local governments, and with local branches of major national financial institutions, and with all local credit groups. Political influence is brought to bear in negotiating annual contributions to the Guarantee Funds.

The costs of the Japanese system are difficult to determine, since the credit guarantee corporations have other sources of revenue besides guarantee premiums. One study estimated that the actual cost of the system to the government, including the administration costs of the guarantee institutions, was 2.0% of the guaranteed amount in 1978. The banks contribute a further 0.9% through their lower interest rates, while the borrowers make a marginal contribution of 0.1%. Loss rates actually fell slightly in the years 1979-81, since the absolute value of payments in subrogation (net of recoveries from borrowers) increased less rapidly than total obligations outstanding.

NEW ZEALAND

A loan guarantee scheme for small-scale industries was introduced in New Zealand in November 1978 by the Small Business Agency (SBA), a division of the Development Finance Corporation of New Zealand (DFCNZ). The object of the scheme was to enhance the borrowing capacity of small businesses which were unable to provide adequate collateral for regular loans. In addition to administering the guarantee scheme, the SBA provides advisory and referral services, develops small business education and training programs, and produces publications on specific topics for small businesses. The main features of the guarantee scheme are as follows:

Eligibility. SBA loan guarantees are available to small firms engaged in manufacturing, processing, tourism, craft development, and technology development. Companies providing services which contribute to New Zealand's foreign exchange earnings or savings are also eligible. While the guarantees are primarily issued for fixed capital loans, they are occasionally issued for working capital also. The maximum amount of the loan must not exceed NZ\$200,000 (NZ\$1 = US\$0.50 in December 1985). There is no minimum amount, but firms seeking less than NZ\$5,000 are normally encouraged to seek bank assistance without a guarantee.

Guarantee Fee. The guarantee fee is normally 2% of the guaranteed amount, but may be higher in cases of greater risk. If the period of guarantee coverage exceeds twelve months, an annual charge of NZ\$100 or 2% of the remaining liability, whichever is greater, is levied.

Risk Sharing. The guarantee covers 100% of the loan amount, to a maximum of NZ\$200,000 per borrower. There is an overall exposure limit of NZ\$10 million for the whole scheme.

Operation of the Scheme. From the beginning of the scheme in November 1978 up to December 1985, 450 guarantees amounting to NZ\$15,389,000 were approved. The average size of a guarantee was approximately NZ\$34,000. During the same period, 13% of the approved guarantees were invoked because of default, and a total of NZ\$1,996,700 was paid out in claims on these guarantees. The administrative costs for the scheme were NZ\$58,562 for the year ending March 31, 1985, while the amount received in guarantee fees was NZ\$63,847.

PART II

SCHEMES IN OPERATION IN DEVELOPING COUNTRIES

CHAPTER 5

ASIA

INDIA

A credit guarantee scheme for small-scale industries was introduced by the government of India in 1960 in 22 selected districts as an experimental measure. The scheme was later (1963) extended to the whole country. The object of the scheme was to increase the supply of institutional finance to small-scale industrial borrowers by reducing the risk of such lending to financial institutions. The original scheme, operated by the Reserve Bank of India, was modified several times to make it more flexible. It was eventually decided that all credit guarantee schemes should be brought together in one organization, the Deposit Insurance and Credit Guarantee Corporation, with a view to improving coordination and operational flexibility. In 1981 the corporation was given the responsibility of discharging obligations arising from the previous guarantee scheme. The corporation introduced a new credit guarantee scheme of its own on April 1, 1981.

The main features of the scheme are as follows:

Eligibility. The guarantee scheme covers credit for both investment and working capital for small-scale industrial units and small scale ancillary units engaged in the manufacture, processing, of goods, or servicing and repair workshops. Small-scale industrial units are defined as those whose investment in plant and machinery does not exceed Rs 3.5 million (approx. US\$291,666). Investment in ancillary units cannot exceed Rs 4.5 million. This definition set in March 1985 represents an increase in asset size on the previous limit of Rs 2 million.

Participation in Scheme. Participation in the guarantee scheme is voluntary, and guarantees under the scheme are available only to institutions that enter into agreements with the corporation. Once a credit institution joins the scheme, however, the guarantee cover is automatic and covers all credit granted to specified categories of borrowers. Participating credit institutions are not free to exclude any eligible borrowers from the guarantee cover.

Guarantee Fee. The guarantee fee is 0.5% per annum on aggregate credit up to Rs 25,000 (about US\$2,083) and 0.75% for credit above Rs 25,000. The guarantee fee is determined on the outstanding balance and is payable half-yearly in advance.

Risk Sharing. The scheme provides for reimbursement of 60% ^{3/} of the amount in default for credit extended up to Rs 0.2 million. In the case of advances in excess of Rs 0.2 million, a reduced guarantee cover of 50% is provided except in the case of small scale industries in the backward areas where guarantee cover continues to be available at 60%. The maximum claim liability per borrower is Rs 1 million. Thus, in the event of a loss on a large loan made by a bank, a major share of the loss would have to be borne by the bank itself.

^{3/} The proportion was 75% up until 1984 when it was reduced to 60%.

Funding of the Scheme. The credit guarantee scheme is operated by the Deposit Insurance and Credit Guarantee Corporation, which is a wholly owned subsidiary of the Reserve Bank of India with a paid-up capital of Rs 500 million (US\$41.7 million) invested in government securities. The share capital of the corporation is held in a general fund.

The administrative expenses of the corporation are met entirely from interest on investments of the general fund. Resources from another fund called the credit guarantee fund are used solely for meeting credit guarantee claims. Funding for this credit guarantee fund comes from the fees received for guarantees given by the corporation and the interest on investments of this fund. It is the hope of the Credit Guarantee Corporation to be able to cover all claims from the credit guarantee fund.

Claims Procedure. The guarantee is not invoked merely because of default if there is a chance that the defaulting borrower can be rehabilitated. Such rehabilitation usually requires additional lending, and in the event of a later default the guarantee organization may question the judgement of the bank in advancing further credit. This naturally leads to differing opinions as to whether a particular defaulter can be rehabilitated. Institutions are expected to take effective steps against the available collateral of any defaulter and only then to invoke the guarantee for the balance outstanding. There is no time limit fixed for invoking a guarantee.

The conditions to be complied with before a claim can be invoked are: (1) the loan under guarantee has not been repaid within one month from the date on which a notice of demand for repayment of the entire amount due was served on the borrower; (2) the loan is treated by the credit institution as a "doubtful debt" and it has been provided for as such in the accounts of the credit institution. At the time they invoke a guarantee, credit institutions are required to certify that the loss has not arisen due to negligence in appraisal, supervision, and follow-up of borrowers. This sometimes leads to disagreement as to whether in fact there has been any negligence.

Operation of the Scheme. Outstanding guarantees increased from approximately Rs 30 million in 1960-61 to Rs 21.9 billion in 1976-77 to Rs 58.4 billion (close to US\$4.9 billion) at the end of 1985. The number of participating credit institutions stood at 449 on January 1, 1986. These included the State Bank of India and its subsidiaries, all the nationalized commercial banks, most of the other smaller private banks, state financial corporations, regional rural banks, other State development agencies, and cooperative banks.

As of December 31, 1984, 7,360 claims amounting to Rs 804.2 million (around US\$67.0 million) were pending under the Government's previous scheme. These claims are not paid from the credit guarantee fund but from funding received directly from the central government. During the year 1985, 5,259 claims with an aggregate amount of Rs 140.7 million were received, while 8,597 claims amounting to Rs 319.6 million were disposed of (i.e., paid out, rejected, or withdrawn). Of this, 5,325 claims amounting

to Rs 129.2 million were paid out, 3,085 claims amounting to Rs 172.4 million were withdrawn and the remaining 187 claims amounting to Rs 18.0 million were rejected. As on December 31, 1985, 4,022 claims amounting to Rs 625.3 million were pending.

Under the corporation's scheme (new scheme), 12,991 claims for an aggregate amount of Rs 689.1 million were pending as of December 31, 1984; these are the corporation's liability. During the year 1985, 22,048 claims with an aggregate amount of Rs 719.9 million were received, while 22,791 claims amounting to Rs 250.8 million were disposed of. Of the claims disposed of, 18,264 claims amounting to Rs 120.6 million were paid out, 4,116 claims amounting to Rs 116.1 million were withdrawn and 411 claims amounting to Rs 14.1 million were rejected. As on December 31, 1985, 12,248 claims amounting to Rs 1,158.2 million were pending.

The average size of a claim was Rs 30.9 thousand (US\$2,575) under the corporation's scheme, and Rs 20.2 thousand (US\$1,683) under the government scheme. Under both schemes the average size of the claims paid out was much smaller than the average size of the claims withdrawn or rejected, which in turn was smaller than the average size of claims still pending. This indicates that the financial institutions are encountering difficulty in collecting on their larger claims. Under the corporation's new scheme, the average size of claims paid out was only Rs 7.8 thousand as compared to an average claim size of Rs 30.9 thousand and an average size of claims still pending of Rs 94.6 thousand. Under the previous government scheme, the average size of claims paid out was Rs 13.5 thousand as compared to an average claim size of Rs 20.2 thousand and an average size of claims still pending of Rs 155.5 thousand.

The Credit Guarantee fund had a balance of Rs 1.18 billion at the end of 1984 and had receipts totalling Rs 1.06 billion in 1985. Income in 1985 by way of guarantee fees and interest amounted to Rs 1.35 billion. The claims paid out under the various schemes operated by the corporation, as well as the estimated liability in respect of claims submitted to the corporation but not yet admitted at the end of 1985 amounted to Rs 1.21 billion (over US\$101 million). At the end of 1985 the Credit Guarantee fund had a balance of Rs 1.25 billion. This serves as a reserve for future claims.

The data on receipt, claims and outflows of the credit guarantee fund for 1984 indicates that claims submitted to the corporation for the first time exceeded receipt of guarantee fees (claims totalled Rs 1.05 billion, while fees only added to Rs 879 million). This trend is likely to increase in the near future due to the large and growing percentage of bank credit tied up in loans to sick industries. This situation raises doubts on the long-term financial viability of the scheme.

Evaluation of the Scheme. The voluntary nature of the guarantee scheme has been questioned by several financial institutions (most notably the commercial banks and state financing corporations) that are required to

offer guarantees to make their loans eligible for refinance from IDBI.^{4/} This, in effect, virtually makes the guarantee cover compulsory for a large number of financial institutions. Several financial institutions have urged IDBI not to insist on the guarantee cover. Also the nationalized commercial banks believe that they have little choice but to use the guarantee cover because the guarantee scheme is operated by a "sister" public sector institution.

The major complaint of the financial institutions has concerned the acceptance and settlement of claims. Under the original scheme, claims were to be settled within a month of filing. In practice it takes much longer; some banks state that in the past many claims were not settled for 2 years or longer but the CGC has reported more recently that claims are now settled with less delay. The amount of the pending claims also lends credence to complaints about slow settlement. This in turn reduces the appeal of the guarantee scheme to financial institutions. While conceding delays in the settlement of claims, representatives of the Credit Guarantee Corporation argue that banks do not always adhere to the conditions laid down in the guarantee agreement. Branch banking leads to further delays, since the head office of a bank must serve as an intermediary between a particular branch and the Credit Guarantee Corporation whenever a question is raised. There have also been disagreements between banks and the Credit Guarantee Corporation on the interpretation of certain clauses in the guarantee agreement. Some of the questions involved include: (1) whether the firm to which the bank granted credit falls under the definition of a small-scale firm; (2) whether overdue interest should have been included in the amount in default; (3) whether due control was exercised by the bank on the end-use of funds by the borrowers; (4) whether there was negligence on the part of the bank in appraisal, supervision and follow-up.

While admitting to some lapses, officials of the financial institutions point out that from a practical point of view it is very difficult to fulfill all the required conditions for all loans. They think that the guarantee corporation should go by the spirit of the agreement rather than by the letter, especially in the case of smaller loans. Arguing that the guarantee corporation has often rejected their claims on flimsy grounds, thereby reducing the credibility of the guarantee corporation. The lending institutions claim that this results in loss of confidence in the scheme.

The Credit Guarantee Corporation some years ago changed the procedure which the financial institutions' complain has caused lengthy delays in the settlement of claims. Earlier issue of a recall notice by a bank was sufficient to lodge a claim but under the changed procedure a claim could be made only after exhausting all possible courses of action which in some cases could take years.

Another issue of concern to financial institutions has been the method for computing the guarantee fee. The guarantee fee is payable on the entire outstanding loan, whereas the guarantee cover is limited to a

^{4/} IDBI - Industrial Development Bank of India.

ceiling of Rs 1,000,000. The financial institutions feel that this procedure in effect makes the guarantee fee very high in relation to the amount of guarantee coverage provided. Guarantee corporation officials justify this procedure by saying that this is one way to collect enough fees to make the scheme fully self supporting, without raising the guarantee fees for all borrowers.

Conclusions. Two questions arise in relation to the operation of the credit guarantee scheme in India, namely, whether the introduction of the scheme has increased the flow of credit to small scale industries; and whether the guarantee cover is still needed. The introduction of the credit guarantee scheme was additional to other major programs and measures designed to provide credit to small-scale industries. One cannot therefore attribute the increased flow of credit to small scale industries over the years only to the credit guarantee scheme. Policy decisions of the government had much to do with the increase. However, the impression gained from several commercial banks is that the existence of the guarantee scheme has had a favorable psychological effect on branch managers by persuading them to provide credit to small-scale industries which would not or could not provide adequate collateral.

To answer the second question, one must go back to the original objective of the guarantee scheme, which was to encourage increased credit to small-scale industries by reducing the higher risk considered to be part of such lending. This objective may no longer be valid. Today, by virtue of their charter, financial institutions must lend to small-scale industries. The major banks in the public sector are mandated by law to lend a substantial portion of their loanable funds to this sector as well. Therefore, it may be that no further inducements are needed to increase lending to small-scale industries.

Participation in the credit guarantee scheme by financial institutions has been fairly widespread. However, several features of the scheme may need to be reexamined, such as its so-called "voluntary" character, the manner in which the guarantee fee is levied, and the procedures for invoking the guarantee by the financial institutions, and for settlement of claims.

INDONESIA

In 1971 the Indonesian government set up Askrindo, a publicly financed credit insurance corporation, to provide coverage against defaults on business loans to both large and small enterprises. After the introduction in 1974 of the KIK/KMKP lending program, through which Bank Indonesia made small credits available for fixed asset investment and working capital for indigenous small enterprises, Askrindo insurance coverage was provided also for loans under this program. The loans, given mainly through banks (mostly state-owned), are rediscounted 75% by Bank Indonesia.

Guarantee Fee. Askrindo charges a one-time guarantee fee of 3% for 3 to 5-year loans. Half of the cost is borne by the administering bank, and half by the Central Bank. The fee is 1% for loans of a year or less.

Risk Sharing. Askrindo provides a guarantee for 75% of each loan. As of 1983, loans under KIK/KMKP were limited in amount to the equivalent of about \$15,000.

Operation of the Scheme. The annual volume of loans insured under the program rose from \$60 million in 1974 to \$270 million in 1978. In 1981-82, over 56% of KIK/KMKP credit went to trade, 9% to agriculture, 13% to services, 12% to manufacturing, and the remainder to other sectors.

In 1980-82, efforts were made to strengthen Askrindo's organizational structure and management in order to support the expanding KIK/KMKP lending program more effectively. While these measures appear to have been successful in speeding up the claims procedure for KIK/KMKP losses, it was felt by 1983 that the role of Askrindo needed to be reexamined further to determine whether Askrindo's operating policies cause it to assume a disproportionate share of the repayment risk, given the premiums it receives, and whether the terms and conditions of Askrindo's coverage give banks less incentive to pursue loan repayments vigorously. Claims for losses on loans insured by Askrindo have been rising steadily since 1979; claims on KIK/KMKP losses rose from Rp 6.0 billion in 1981 to Rp 13.2 billion (around \$13 million) in 1982.

At the end of 1983 it was claimed that Askrindo's over-generous terms had contributed to a high arrears and default rate in the KIK/KMKP programs, and it was proposed that the proportion of loans insured by Askrindo be reduced from 75% to around 60% and that the premium be raised from 3% to 4%. The additional 1% was to be paid by the borrower. As of mid-1985 the proposed changes were still being studied.

REPUBLIC OF KOREA

The Korea Credit Guarantee Fund (KCGF) was established as a special public corporation by the Credit Guarantee Fund Act of June 1976. Its major activities include a credit guarantee service, the provision and management of credit information, as well as technical assistance for small and medium-industry. The declared purpose of the KCGF is to make finance available for business firms by guaranteeing payment of the liabilities of these firms.

KCGF has 16 departments in its head office and 24 branches throughout the country; at the end of 1982 it had close to 1,300 employees. The board consists of 15 members including the president of the KCGF, who is also the chairman of the board, one person from the Ministry of Finance, 8 executives of financial institutions, and 5 representatives of private enterprises.

The following are the major features of the KCGF's operation:

Eligibility. KCGF extends guarantees for loans issued by banks for bonds, for payment of taxes and duties, for bills, for loans by non-banking financial institutions, and for leases. Guarantees for taxes and duties are designed to relieve a company of immediate cash expenditures by deferring the payment of taxes and duties. Guarantees for leases can be used as required collateral when a business firm leases production facilities. Guarantees for bills can be used as a guarantee for payment of notes payable or receivable and collateral bills. Creditworthy business firms which lack sufficient collateral can make use of KCGF when they borrow money from banks, short-term finance companies, and insurance companies by furnishing a letter-of-credit guarantee from KCGF. Before the issuance of a letter-of-credit guarantee, KCGF reviews the application, interviews the entrepreneurs, and conducts a credit investigation and analysis. Guarantees are approved only after thorough screening. KCGF covers all types of enterprises except forestry, fishing, agriculture, and real estate. KCGF also provides information on the credit rating of enterprises.

The maximum guarantee depends on the scale of the business. The maximum for large business is W 1 billion ^{5/}, for small and medium-sized business W 800 million, and for very small business 100 million Won. However in sectors designated as of special importance to the development of the economy, the maximum limit of guarantee has been set at W 5 billion for large businesses and W 3 billion for SMI. An enterprise is considered a small and medium-sized business if it employs less than 300 persons and is classified as very small if it employs less than 50 persons.

Guarantee Fee. The guarantee fee is 1% per annum of the amount guaranteed, for all types of guarantees.

^{5/} US\$1 = W 750 (1982)/W 870 in June 1985.

Risk Sharing. The guarantee covers 80% of the loan amount.

Funding of the Scheme. KCGF is funded by the government by means of a levy imposed on the profits of all banks and by the 1% per annum guarantee fee. The initial capital was W 33.2 billion (approximately US\$73 million) and had grown to W 139 billion (approximately US\$190 million) as of December 31, 1981. The total of all guarantees available for business firms is 15 times the capital of KCGF. When the KCGF was established in 1976 the ratio of 15 times was considered adequate to cover the demand for guarantees. But during the next 6 years the scale of business activity exceeded expectations. As a result, the total guaranteed balance jumped from approximately 3 times the capital of KCGF in 1976 to more than 11 times the capital in 1981 but dropped again to 7 times in 1985. The total guarantees reached a peak of 12.09 times the capital funds in 1982.

Claims Procedure. When a company defaults, KCGF subrogates the amount of the balance on its credit guarantee accounts to the banks. The organizations concerned are compensated for their loss directly by KCGF.

Operation of the Scheme. As of December 31, 1981, the outstanding balance of guarantees issued reached the sum of W 1,544 billion (US\$2 billion approximately), an increase of 23% over that of the previous year. In 1985, it reached W 1,895 billion (around US\$2.3 billion) ^{6/} Credit guarantees for small business stood at 40.9% of all guarantees in 1976, 56.8% in 1979, 63.1% in 1981, 81.6% in 1983, and 90.6% in 1985. Meanwhile, the proportion of credit guarantees for large business has been steadily declining. A breakdown of KCGF guarantees by type of industry and by type of guarantee is given below.

Evaluation of the Scheme. By all accounts the KCGF has been effective in providing guarantees to small and medium firms seeking loans, although there is evidence that its main activity has been the guaranteeing of loans given by the three government owned banks--the Small and Medium Industry Bank (SMIB), the Citizens National Bank (CNB), and Korean Development Bank (KDB) rather than guaranteeing loans given by commercial banks. Detailed figures are not available on claims made against guarantees, but it is known that there were very few before 1979. After 1980, due to more difficult economic conditions, defaults and claims against KCGF increased considerably. The profit and loss statements for 1984/85 (see Table 5-1) show that there were significant net losses on operations. It is also evident from the statement that due to large reserves created during the initial funding of KCGF, the fund earned substantial interest on its holdings. Income from the guarantee fee covered "General and Administrative Expenses" up to 1982 but by 1984-85 the fees no longer covered these costs.

^{6/} There was a decrease to W 1,310 billion in 1983.

Credit Guarantee by Economic Sectors
(as of end 1981) - (Unit: 100 mil. Won)

<u>Type of Business</u>	<u>Amount</u>	<u>Ratio</u>
Manufacture	11,122	72.0
Wholesale & Retail	1,192	7.7
Mining	98	0.6
Construction	2,402	15.6
Transportation & Storage	481	3.1
Others	147	1.0
<u>Total</u>	<u>15,442</u>	<u>100.0</u>

Credit Guarantee by Type of Guarantee
(as of end 1981) - (Unit: 100 mil. Won)

<u>Type of Guarantee</u>	<u>Amount</u>	<u>Ratio</u>
Guarantees for loans	8,582	55.6
Guarantees for payment issued by banks	1,615	10.4
Guarantees for loans of Non- Banking Financial Insti- tutions	795	5.2
Guarantees for Leases	252	1.6
Guarantees for Bonds	3,707	24.0
Guarantees for Bills	428	2.8
Guarantees for Taxes and Duties	63	0.4
<u>Total</u>	<u>15,442</u>	<u>100.0</u>

MALAYSIA

The Credit Guarantee Corporation Malaysia Berhad (CGC) was established by Bank Negara Malaysia in 1972 with the primary objective of encouraging commercial banks to extend more credit to small-scale enterprises. It was established as a limited company with a paid-up share capital of M\$2.5 million. Shares were held jointly by Bank Negara and all the other commercial banks licensed to operate in Malaysia.

The CGC has undertaken two credit guarantee schemes; (1) the CGC General Scheme (CGC/GS) which was started in January 1973, and (2) the CGC Special Loan Scheme (CGC/SLS), which was started in January 1981.

CGC General Scheme

The general features of the CGC/GS Scheme are as follows:

Eligibility. Companies with paid-up capital and reserves not exceeding M\$100,000 are eligible, provided they are registered, operated, and owned by Malaysian citizens. The maximum loan limit that can be guaranteed is M\$100,000 and M\$200,000 for Bumiputras (ethnic Malays), with the ceiling per loan at M\$30,000.

Guarantee Fee. The guarantee fee is 0.5% per annum of the outstanding loan amount. The interest rate for loans is set at 1% below the base lending rate.

Risk Sharing. The risk covered by the guarantee is 60% of the outstanding loan amount.

Claims Procedure. The CGC has the right to reject claims if the quality of loan appraisal and follow-up by the individual bank is found to have been poor. It is the responsibility of the participating banks to ensure that the loan is actually used for its intended purpose, and also for recovering amounts due under the guarantee scheme. Before submitting a claim to CGC the banks must take all possible legal steps to recover the loans. The costs of legal action must be borne by the banks themselves. To alleviate some of the burden of legal costs on the banks, the CGC waived requirement of legal actions on claims for loans below M\$5,000, provided that legal action is taken on one out of every five such cases.

CGC Special Loan Scheme

The Special Loan Scheme (CGC/SLS) was introduced by the CGC in January 1981. The CGC/SLS differs somewhat from the CGC/GS.

Eligibility was widened to include all registered businesses with net assets of less than M\$250,000 or limited companies with eligible shareholders funds of less than M\$250,000, with a loan limit in both cases of M\$250,000. The maximum loan under the CGC/SLS is M\$50,000 for each borrower, which can form part of total borrowings up to the M\$250,000 limit.

The CGC/SLS guidelines also state that the loans may be made without security unless the loan is used to buy fixed assets. No penalties are levied on banks for taking additional security. In practice, therefore, the banks in many cases have obtained additional security against their SLS loans.

Another difference between the two schemes is the interest rate charged. Under the CGC/SLS the interest rate is 7.5% per annum, as compared to 8.5% per annum under the CGC/GS.

Operation of the Schemes. In 1973, the CGC's first year of operation, 2,292 loans amounting to M\$11.8 were approved, of which M\$5.9 million was disbursed. In 1976, there was a sharp increase in the total amount of loan approvals to M\$164.3 million. By 1981 the loan approvals increased to M\$523.9 million on a total of 18,309 applications. Since then, however, loan approvals dropped to M\$519.3 million in 1982 and M\$298.3 million in 1983.

The corporation's portfolio as of December 1982 included 71,288 loan accounts with an approved value of M\$1,374.98 million. Loan cancellations (including loan repayments and loans reclassified outside the schemes for a variety of reasons) totalled 7,330, with an approval value of M\$150.31 million during the year. Deducting these, and adding on the new loans approved, net outstanding loans accepted for guarantee at the end of 1983 totalled 74,521 and were valued at M\$1,522.99 million. The outstanding value of these loans amounted to M\$964.85 million as of December 1983, giving a utilization rate of 63.4%. By end 1985 there was a total of approximately 80,000 accounts with CGC, covering a total outstanding loan amount of M\$850 million.

Loans guaranteed by the CGC were directed at three broad sectors --business, agriculture, and industry. Lending to the general business sector accounted for the largest share (80%) while agriculture and industry each received 10%.

The handling of claims has been very poor, as the figures show. Up to December 31, 1981, a total of 1,342 claims amounting to M\$4.39 million had been lodged with the CGC. Of these, only 132 claims for M\$277,787 had been paid out, while 760 claims for M\$2.17 million had been rejected. In 1983 a total of 254 claims amounting to M\$1.9 million were considered. Total settlements made by the corporation in 1983 amounted to M\$117,122 on a total of 94 loans, compared with M\$77,000 on 45 loans in 1982. By end 1985 a cumulative total of 1,935 claims had been processed, with an additional 127 involving an amount of M\$1.45 million still outstanding. Of the claims processed only 429 were paid out, involving a total sum of M\$1.27 million. Of the remainder, 1,186 claims were rejected (for M\$6.44 million) and 320 were withdrawn by the banks. Most of the claims considered were rejected or found not eligible for compensation on the ground that they did not comply with the terms and conditions of the guarantee cover. These figures explain some of the loss of confidence of the commercial banks in the scheme.

The Malaysian scheme seems to have been poorly planned in that inadequate provisions were made for handling claims. Five years after the central bank guidelines for CGC guarantee loans were introduced, the CGC's capital fund (including provisions for claims) amounted to only 4.4% of its guarantee obligations, while doubtful accounts reported by the participating banks amounted to 20% of the outstanding guaranteed credits. The scheme seems to have been introduced with the aim of helping Bumiputras or indigenous Malays--without real thought as to what the costs of the scheme would be. Perhaps the most disturbing features of the CGS is that even after 10 years of operation, it has not yet a clear picture of the risks associated with small-scale businesses in Malaysia. Although CGC issued guidelines (in 1985) to commercial banks relating to the credit analysis of their small-scale client, it remains a passive institution which tries to keep its liabilities to a minimum by rejecting claims on grounds of "administrative irregularities."

In 1982, at the request of the Malaysian government, the World Bank sent a consultant to Malaysia to review the scheme. One of his findings was that the scheme was grossly underfunded in light of the volume of guarantees given. The consultant also recommended raising the guarantee fee to 1% and the share capital to M\$40 million, and pointed out that these measures alone would not make the CGC solvent unless the manner of its operation was changed.

NEPAL

The "Credit Guarantee Corporation" was established in Nepal in 1974 with the purpose of guaranteeing the loans advanced by commercial banks to the agriculture, industry, and service sectors. In addition to the Government of Nepal, Ministry of Finance which owns 40% of the shares of the corporation, the other shareholders are Nepal Rastra Bank (i.e., the Central Bank of Nepal, 44%), Nepal Bank Limited and Rastriya Banijya Bank (8% each). The Board of Directors of the Corporation consists of one representative each from the Government of Nepal, Nepal Bank Limited, Rastriya Banijya Bank, and three from Nepal Rastra Bank. The objective of the scheme was to increase the supply of credit to generate income to low income groups and create employment opportunities. Prior to the establishment of the Credit Guarantee Corporation the share of commercial bank lending to small enterprises was minimal because of their perceived higher risk and their inability to provide adequate collateral. It was felt that commercial banks were in a position to increase lending to the high priority small enterprise sector since they controlled most of the financial resources and had extensive branch networks. The main features of the guarantee scheme are as follows:

Eligibility. Credits advanced by members institutions up to NRs 0.2 million (US\$10,000) per loan in the agriculture and service sectors and NRs 1 million (US\$50,000) per loan in the industry sectors is automatically guaranteed under the scheme. The banks are required to send quarterly statements to the CGC giving all the details of loans such as name of borrower, purposes of the loan, amount, maturity date, etc.

Guarantee Fee. The guarantee fee is fixed at the rate of 1% per annum or 0.25% per quarter on quarterly balance outstanding on the total amount of loans advanced. This fee was raised to the present level from 0.75% in early 1986.

Risk Sharing. The corporation reimburses the member institution after scrutinizing the claim documents. The reimbursement provided is 75% of the outstanding loan, and of this amount CGC pays out 50% as advance compensation upon receipt of a claim and the remainder only after receiving the report of an auditor identifying that the loan is unrecoverable. Recently, CGC has made some changes in the filing of claims. In some instances a member institution can now file a claim before the due date of the loan if there is a default due to natural calamities or reasons beyond control of the borrower. It is the responsibility of the member institution to proceed with recovery of the loan from the borrower. The member institution is to take actions against the borrower to recover the loan within six months of receiving compensation from CGC.

Funding of the Scheme. The CGC was initially established with an authorized, issued and paid-up capital of NRs 3 million. At present (1986), the authorized capital stands at NRs 60 million, the issued capital at NRs 30 million and the paid-up capital at NRs 15 million. Out of the

paid-up capital of NRs 15 million, NRs 7.5 million is owned by the Government of Nepal, NRs 5.5 million by Nepal Rastra Bank and NRs 1 million each by the two commercial banks, Nepal Bank Limited and Rastriya Banijya Bank. Additional funding for the guarantee scheme comes from the guarantee fees and the interest earned on investment of this fund. After operating under the central bank's priority sector lending guidelines for seven years, the CGC's capital fund amounted to 8.6% of its guarantee obligations, while reported overdue loans amounted to 52% of outstanding guaranteed credits; the situation had not improved significantly up to 1986 despite a 3.6 times increase in the CGC's capital fund.

Operation of the Scheme. The central bank lending guidelines for the priority sector were introduced at the same time as the establishment of the CGC; all priority sector loans below a certain size were to be automatically guaranteed by the CGC. As a result it is difficult to determine to what extent the commercial banks would have used the services of the credit guarantee organization if they had been provided on a completely voluntary basis. One immediate result of the imposition of the central bank guidelines was that, because the commercial banks were completely unprepared for lending on a large scale to the small-scale sector, many of the guaranteed small loans made for the first 5-6 years were not properly appraised, and supervised. The situation was further exacerbated by interest rate ceilings imposed on guaranteed loans which did not allow the commercial banks a large enough spread to take into account the higher administrative costs of lending to this sector. The overall result was that a large number of guaranteed loans went to small enterprises which were not viable. The loans were not properly utilized, went to ineligible enterprises or for ineligible purposes, and in most cases fell into arrears. Since guarantees were provided virtually on an automatic basis, the volume of guaranteed obligations grew rapidly in line with the central bank lending guidelines; however, CGC had no control over the quality of the credits which they guaranteed. Also, as credits were accepted for guarantee without any screening, deficiencies in meeting the guarantee guidelines were usually not discovered until claims were scrutinized; at which point the claims were rejected. The commercial banks then realized they would have to improve their loan processing procedures in order to be able to have their claims approved. However, the inadequate interest spread they received for loans under the central bank guidelines did not allow them to take steps to improve the situation without affecting their profitability. Accordingly they resorted to other means to reduce their risk, such as taking full collateral coverage against guaranteed loans, or allowing the loans to be used improperly but with less risk for such purposes as making fixed deposits, which essentially defeated the purpose of the guarantee scheme. A World Bank adviser reviewed the scheme in April 1986 and made recommendations for changes.

PHILIPPINES

The Industrial Guarantee and Loan Fund (IGLF) established in 1952 under an agreement with the predecessor to USAID is not really a guarantee scheme in the pattern of the others described in this paper. The main function of the IGLF was to provide credits to the small and medium industries (SMI) by refinancing loans made by financial institution to SMI borrowers. To provide an incentive to financial intermediaries to use the loan fund, part of the loan made was guaranteed. The IGLF had only very limited success in its first years of operation and was little used by banks.

The World Bank became associated with IGLF in 1975, when changes were introduced, particularly in the composition and role of the Inter-agency Review Committee (RC) which advises and supervises IGLF on policy matters. Previously, each loan submitted for rediscounting and for guarantee had to be reviewed and approved by the RC. On the Bank's advice, a system of RC accreditation of financial institutions was adopted; after such accreditation, any loans from the institution to SMI conforming to the directives of the IGLF were automatically rediscounted and guaranteed to a maximum of 60%. Since 1976, therefore, accredited financial institutions have taken full responsibility for appraising and approving projects submitted for financing. This has reduced the time taken to approve loans from months to a few days, once appraisal is completed.

The RC originally included representatives of the National Economic Development Authority (NEDA), the Central Bank (CB), the University of the Philippines Institute of Small Scale Industries (UP-ISSI), and the Ministry of Industry (MOI). In 1978 the membership was broadened to include a representative from the Ministry of Finance (MOF), and the level of representation was upgraded to give the RC greater influence on the formulation and implementation of policies and programs. Since investment decisions are now made by the accredited lending institutions and merely reported ex-post to the RC, the latter can pay more attention to policy issues.

The IGLF program is administered by the Central Bank's Department of Loans and Credit (DLC). This unit now engages mainly in promotional work to increase the use of the IGLF, which involves identifying and evaluating institutions for accreditation, and monitoring of their operations. It was found that some financial institutions, mainly rural banks, were not able to meet the requirements for accreditation, but they were allowed to use the IGLF on an 'ad hoc' basis, submitting each case for approval; these applications are processed by a special division in the IGLF unit of the DLC. The professional staff of this unit grew from 18 in September 1975 to 23 in November 1978, to 43 in 1980 and 66 in 1982.

The main features of the guarantee scheme are as follows:

Eligibility. Loans made to cottage small and medium-scale industries in the manufacturing and service sectors by participating

intermediaries, are eligible to receive guarantees. Cottage industries refer to enterprises with assets of not exceeding ₱250,000 (US\$12,500 in 1986), small-scale industries have assets above ₱250,000 but not more than ₱2.5 million. Medium-scale industries are those whose assets are in excess of ₱2.5 million, but not more than ₱10 million.

Participation in the Scheme. In order to have access to the IGLF both for rediscounting and guarantee coverage, financial institutions--commercial savings banks and non-bank financial intermediaries--must be accredited by the Central Bank. To meet accreditation requirements, a financial institution must have a specified minimum net equity, a loan portfolio with arrears below a given level, and sufficient staff for loan appraisals and efficient disbursement. In all 34 institutions ^{7/} were accredited by 1985, 18 of them being commercial banks, 7 were non-bank financial intermediaries (NBFI) 2 were savings/mortgage banks and 7 were private development banks (PDB). In general, the accreditation scheme has worked quite well, despite a slow response of the institutions, but the view has been expressed that the performance of the accredited institutions should be more closely monitored. In recent years the DLC has withdrawn accreditation from institutions when the arrears ratio of the portfolio passed 15%.

Guarantee Fee. The fee charged is 2% of the guaranteed percentage of the loan outstanding. The fee for a collateral-short guarantee is passed on to the borrower while the fee for a credit-risk guarantee is absorbed by the financial institution making the loan.

Risk Sharing. The IGLF originally offered two types of guarantees. The first type--collateral-short guarantee--was available for small loans to cover collateral deficiency up to an amount equivalent to 25% of the loan amount. This would be a fixed absolute amount guarantee which covered first losses to the extent of the guarantee or the loan outstanding whichever was lower. The second type was a credit-risk guarantee for small and medium loans for an amount not exceeding 60% for small loans and 40% for medium loans. In practice, no use was made of the "collateral-short" guarantee until late 1982 and then only in a small number of cases. Lenders preferred to take collateral and accept the guarantee as extra coverage for 40 to 60% of the loan. The IGLF also originally offered accredited institutions a straight guarantee up to a maximum of 80% of loans if the lending institutions made use of its own funds, but no institution has made use of this arrangement.

In 1982, total lending through IGLF reached ₱188.3 million (US\$26 million)--about 26% was through commercial banks and 62% through non-bank financial intermediaries. Two of the latter (PDCP and MANPHIL) probably accounted for around 50% of all IGLF lending in 1982. The commercial bank IGLF portfolio at end of 1984 was ₱530 million (approximately US\$30 million). In the beginning of 1983, some private development banks dropped

^{7/} Following the grave financial crisis in the Philippines in 1985, 10 of these institutions were under receivership and only 21 were active participants of the IGLF.

out of IGLF and started lending to small and medium-industries (SMI) through an arrangement with DBP (Development Bank of the Philippines) which makes loans directly to SMI and not through IGLF.

Settlement of Claims. The time period taken for settlement of claims has been a point of dispute between IGLF and the commercial banks. The commercial banks claim that it takes IGLF over 3-4 months to settle claims. IGLF denies this generally, but states that in specific cases this may be so; it claims the commercial banks are to blame for providing insufficient documentation which causes delays. As virtually all loans through IGLF are made by lending institutions against collateral, in the case of default the lenders are required to take steps to foreclose on all such security to recover what they can before the IGLF will agree to settle claims for outstanding losses. This process takes time.

As of end 1984 there were 79 cases of foreclosure, 18 of these in the year 1984. Based on the claims of the financial institutions involved, IGLF stood to share losses to the amount of ₱1,170,430.20 (about US\$70,000). However, all the claims were in various stages of processing and had not been settled by the end of 1984. Total guarantee fees collected for 1984 amounted to ₱3.440 millions (around US\$200,000). The amount provided for losses against guaranteed loans for 1984 was ₱4,695 millions. The actual amount written off during 1984 was ₱1.048 million (around US\$62,000) to cover IGLF's share of the losses on 8 foreclosed accounts.

One point that emerged from a University of the Philippines/ Institute for Small-Scale Industries study in 1980 of a sample of IGLF borrowers was that the long processing time distorted the calculations submitted, because allowances for inflation were inadequate, and the SMI thus faced financial difficulties from the start. The tendency of the lending institution to approve only part of the amount requested further aggravated the situation.

The data show a diversity of experience among the accredited institutions. Some used IGLF occasionally and selectively, and found it profitable; in the best case the number of arrears has been kept to less than one in twenty. Other institutions have been less discriminating, and have had 50 to 90% of loans in arrears. Clearly, the former group applied stricter standards and invested more effort in loan appraisal, investigation of credit records, supervision and collection. This substantially reduced losses from arrears and defaults but also raised administrative costs. Some banks managed to minimize these costs while still keeping risks low by concentrating only on borrowers with very good credit standing. But this greatly reduced their overall use of IGLF and largely defeated its purpose.

In order to increase use of the IGLF, operational changes were introduced in 1979. The changes raised the effective interest rate to the

final borrower by 1984 from 11% to 21% ^{8/} and increased the spread allowed the participating intermediaries from 5% to 8% for small industry loans and to 6% for medium industry loans. This helped to cover the high transaction costs, and made IGLF more attractive thus encouraging more institutions to seek accreditation. As of 1984, the maximum limit on loan size was raised to ₱10 million (then around US\$600,000) making the program more attractive to commercial banks.

Review of Fund. The scheme appears to have achieved the objective of expanding institutional lending to SMI. Since all lenders continued to require collateral, however, the scheme did not do a great deal to widen access to finance for small industries that could not provide collateral.

As stated earlier the prime objective of the IGLF was to provide credits through a variety of institutions for onlending to small and medium industries. The guarantee of 40-60% of losses was meant to induce banks to lend to under-collateralized borrowers. As most of the financial institutions were unwilling to accept less than 100% collateral before approving a loan, the guarantee through the IGLF only served to increase the cost of borrowing to fully collateralized borrowers since the 2% guarantee fee was passed on to the borrowers by the lenders. Accordingly since 1982 the guarantee coverage became optional and borrowers could use the IGLF without paying for a guarantee. One report shows that during November 1985 out of 33 disbursements from IGLF from a World Bank loan, only 7 borrowers took guarantees. One was for a collateral short guarantee amounting to 20% of the subloan, three others were credit-risk guarantees for 60% and three for credit-risk guarantees for 40%.

In general the IGLF can be considered to have succeeded more as a loan fund and less as a guarantee scheme. Slowly after 1983 some financial institutions did make limited use of the guarantee part of the IGLF to reduce collateral requirements. Still, the IGLF in 1986, after over ten years active operation, refinances 100% of the onlending under IGLF and has not yet succeeded in inducing the financial institutions including the commercial banks to use some of their own funds.

^{8/} In November 1984 the interest rates were raised to 16 to 23%. The spreads were 7% for small industries and 5% for medium-scale industries.

SRI LANKA

Sri Lanka introduced a Small Industries Credit Guarantee Scheme in the 1970s, administered by the Central Bank. This scheme was modified in 1979 to provide guarantees for loans made to SMI through the World Bank line of credit to the National Development Bank (NDB), which was channelled through four commercial banks.

Guarantee Fee. A 1% premium on the outstanding amount was payable by the lending institution. Applications for guarantee coverage were made separately from loan applications, but approval of loans by the SMI Fund facilitated rapid review of guarantee applications by the Central Bank. Early in 1984 it was decided to pass on the charge for the premium on the guarantee to the borrower.

Risk Sharing. Generally, these loans to small enterprises were guaranteed through the Central Bank fund to a maximum of SL Rs 400,000 ^{9/} or 60% of the loan, whichever was less. SL Rs 400,000 represented at that time 40% of the maximum loan size allowed under the World Bank credit line. In 1981, under a second credit line from the World Bank, the maximum was raised to SL Rs 800,000, which was 40% of the increased maximum loan size of SL Rs 2 million.

Evaluation of the Scheme. Even on loans for which guarantees were undertaken, the commercial banks continued to demand collateral, fearing that claims for payment from the fund would run into bureaucratic problems. By early 1983 there were 15 SMI loans against which the Central Bank guarantee had been invoked for an amount equalling SL Rs 5.38 million (about \$240,000). The NDB reported at that time that SL Rs 1.017 million (\$57,000) had been paid out. Also, it was reported in April 1983 that the Central Bank was claiming that insufficient or inconsistent documentation from the banks was holding up payment on claims under the scheme. The banks, in their turn, were losing interest in the guarantee scheme and were demanding collateral. There was also a fall-off in lending to SSE by the banks, but it was not clear to what extent this was linked to dissatisfaction with the guarantee scheme.

^{9/} US\$1 = SL Rs 25.00.

THAILAND

In May 1985 the Asian Development Bank (ADB) approved a technical assistance grant to Thailand to help the Industrial Finance Corporation of Thailand (IFCT) set up a new financial facility, the Small Industry Credit Guarantee Fund (SIGGF). This was designed to promote direct lending by financial institutions to the small-scale industry sector through provision of loan guarantees to enterprises which did not have sufficient collateral to borrow from financial institutions.

SIGGF will be part of IFCT for the first five years of its operations, after which if successful it will become a statutory credit guarantee corporation to be established under a special act of Parliament.

SIGGF's guidelines were only finalized in May 1986 after the first set introduced in November 1985 drew a negative reaction from the bank and small scale entrepreneurs. The SIGGF first wanted the banks to undertake an appraisal of each project similar to one done by a development bank. As this was unacceptable to the banks, considering this too time consuming and administratively costly, the SIGGF agreed to rely on the commercial banks' own credit screening procedures.

In general SIGGF will guarantee 80% of the collateral-short portion of loans but may in exceptional cases cover 100%. In order to simplify procedures the SIGGF agreed to accept the banks' estimate of the collateral available. SIGGF only requires as a minimum that the fixed assets financed under the project be pledged as collateral.

Guarantee Fee. The SIGGF's guarantee fee is 1.5% per annum payable in advance on the guaranteed amount.

Guarantee Fund. The SIGGF was formally established in April 1985 with a capital fund of B 200 millions (US\$7.6 million) contributed by the Thai Government (Ministry of Finance), all the Thai banks and the IFCT.

Eligibility. SIGGF guarantees are available on loans to firms with total net fixed assets of less than B 10 millions. The loan size should be not greater than B 5 millions nor less than B 200,000. Guarantees are available on loans for fixed assets and working capital.

Operations. Initially the SIGGF proposed that claims be paid only after the bank has taken all steps to foreclose on all the security pledged against the loan. The shortfall between the loan amount, including accrued interest, and the recovered amount would be the collateral short amount of which the SIGGF would reimburse 80%. As the SIGGF now accepts the collateral value as estimated by the bank all the claim is settled after the legal proceedings has resulted in a final judgment against the borrower. If afterwards the bank recovers more than the collateral covered portion of the loan from liquidation of the security, it has to share this amount on a "pro rata" basis with the SIGGF.

In the initial months the scheme moved slowly and commercial banks were still reluctant to use it. Only a few guarantees were given out in the first three months.

SICGF may extend guarantees up to 100 percent of each loan made to a small-scale enterprise, but total outstanding guarantees are not to exceed SICGF's total capital funds. It is envisaged that SICGF's operations will be financed by income from guarantee fees and from the investment of SICGF's capital funds in the financial market. The fund is to be a tax-exempt service-oriented entity and is expected to earn enough revenues to make the guarantee scheme self-sustaining in the course of time.

CHAPTER 6

AFRICA

CAMEROON

In Cameroon, a credit guarantee fund (FOGAPE - Fonds d'Aide et de Garantie des Credits aux Petites et Moyennes Entreprises) was established in 1975 to guarantee loans provided either by commercial banks or by Banque Camerounaise de Developpement (BCD) for SME investment projects. FOGAPE is funded partly by subventions from the government and partly through a 10% annual levy on the profits of commercial banks. The guarantee ceiling is set at CFAF 30 million per borrower (equal in 1985 to US\$66,700) or 80% of the loan, whichever is lower.

By November 1981, after six years of operation, the fund had given 159 guarantees and had only four claims of loan defaults, two of these on BCD loans. FOGAPE was allowed to give guarantees up to 7 times its asset base but only had commitments for 1.6 times by June 1980, about five years after starting operations. By June 1984 a total of 268 guarantees had been provided by FOGAPE. Total FOGAPE guarantees amounted to CFAF 3.9 billion (mostly for term loans) as compared with outstanding term credits from the banking sector of CFAF 226 million. These figures put FOGAPE's operations into perspective. FOGAPE's operations were essentially aimed at smaller SMEs, with the average FOGAPE guarantee covering 65% of a loan; in practice, the average loan guarantee amounted to CFAF 14 million (around US\$30,000). Approximately 60% of FOGAPE's guarantees covered loans made by BCD, which also provided the largest loans for which FOGAPE provided guarantees. The smallest loans guaranteed by FOGAPE were extended by the BIAO Cameroon, a commercial bank. For the period from 1975 until June 1983 FOGAPE reimbursed the banks a total of CFAF 51.6 million (US\$114,700) for losses on guaranteed credit and interest, which corresponded to only about 1.4% of the guaranteed amount.

FOGAPE has been criticized by the commercial banks as being "too risk-averse" and for delays in processing guarantee applications through prolonged examination of each request. The drop in the number of guarantees in the 1980-84 period appears to reflect disappointment on the part of banks in FOGAPE. According to reports, the banks continued to require collateral before approving a loan, claiming that they had to wait about six months for FOGAPE to approve a guarantee. They also complained that they had to wait a very long time, often three to four years before FOGAPE paid the guaranteed sum following borrower default.

The difficulties in obtaining approval of guarantees and settlement of claims seem to have caused the banks to stop using the scheme. In principle, according to the guarantee agreement, the banks were required to pay a commission of 1.5%, but in many cases this commission was either not requested or not paid, according to an internal study of FOGAPE's operations.

The number of operations of FOGAPE (268 over a nine-year period) seems small, since the organization had a staff of 35. Staff costs in one year (1981/82) were CFAF 61 million, considerably higher than total repayments over an eight-year period. FOGAPE never seemed to have reached

anywhere near the amount of guarantees it could have given according to its statutes, and the conclusion is inevitable that it followed an excessively cautious approach in processing requests for guarantees.

In 1984 FOGAPE was upgraded into an independent financial institution, but it was not clear by 1985 what this new status signified. Since its establishment, FOGAPE was supposed to have the function of upgrading SMEs through the provision of training, information, and advisory services, but there was little evidence that it had been active in these fields.

GHANA

A Credit Guarantee Scheme (CGS) for small borrowers was established by the Bank of Ghana in 1969 with the objective of increasing the flow of credit to small enterprises. The responsibility for its administration was entrusted to a department of the Bank of Ghana.

Eligibility. All enterprises engaged in extraction, processing, or manufacturing of goods, repairs and services, and road or water transport, with investment in plant, machinery accessories, and other capitalized expenses not exceeding £100,000 ^{10/} were eligible for guarantee coverage. The value of assets was to be based on the original price paid. The duration of the guarantee ranged from one year for short-term credit to term loans of 10 years maximum for acquisition of fixed assets.

Loans to small borrowers in agriculture, livestock, poultry farming, and trade were also eligible under this program. In the years of operation of the scheme, 50% of the credit amount guaranteed and 75% of the number of guarantees issued went to trade. The number of guarantees for small traders dropped as government support for this sector was withdrawn.

In order to achieve the maximum possible coverage of loans to the small-scale sector, it was made obligatory that participating banks cover all eligible loans to small borrowers after December 1, 1969, under the guarantee scheme. However, this requirement was never strictly enforced by the Bank of Ghana.

Guarantee Fee. The guarantee fee charged to the credit institutions was 1% per annum, calculated on the maximum amount of the guaranteed advance sanctioned for short-term borrowing and on the outstanding amount for which a guarantee has been issued for term loans. The guarantee fee was paid by the credit institution and came out of the 6% spread between lending and borrowing rates.

Risk Sharing. The Credit Guarantee Scheme provided a guarantee cover of 66-2/3% up to a maximum of ₵50,000 per borrower (i.e., from all banks, in the event that an enterprise had several guaranteed loans). This meant that the maximum guarantee of 66-2/3% was reached with a ₵75,000 loan.

Funding of the Scheme. At the time the fund was created it was credited with sum of ₵500,000 by the Bank of Ghana. The maximum for total guarantees outstanding allowed under the scheme was fixed at 10 times the balance available in the fund. As a promotional measure the Bank of Ghana decided to bear the administrative expenses of the scheme out of its own revenue. The balance available in the fund as of February 1980 was ₵7.2

^{10/} At that time (1969) the cedi was on par with the U.S. dollar. By 1986, the rate was 90 cedis to 1 U.S. dollar.

million. Over the ten-year period of operation of the scheme (1970-80), the Bank of Ghana contributed an additional 4 million cedis out of its own resources. Revenue from the one percent guarantee fee was 2.14 million cedis, and income from interest bearing accounts was 1.56 million cedis. Claims paid out over the period 1970-80 were reported to be 1.1 million cedis.

Claims Procedure. A decision to invoke the guarantee was based upon the credit institution's assessment of the status of the borrower's account, but temporary defaults were not a sufficient basis for a bank to invoke the guarantee. A bank was supposed to make "normal" efforts to regularize the account and, only if this did not succeed, was expected to submit a claim to the CGS. While a bank was allowed to submit a claim before any legal proceedings had been entered into, it was expected to follow through with efforts to collect the amount in default. Any recovered amount was to be shared with the guarantee fund on a 2:1 basis in favor of the CGS.

Operation of the Scheme. The credit guarantee scheme seems to have operated reasonably well in the early 1970s. Operations peaked in 1975/76, when the annual number of guarantees issued reached 7,000 (including renewals, enhancements, and new loans submitted) with a total amount of over ₵42 million. In the next three years, however, the use of the scheme declined sharply in both numbers of guarantees outstanding and the amount of loans covered. In 1979, only 514 guarantees were issued to cover about ₵10.5 million in loans. The official explanation given for the sharp decline in the use of the CGS was the state of the economy, but this did not fully explain the situation. A contributing factor could be that some of the large participating banks--among them the Ghana Commercial Bank, which in 1976 accounted for 57% of the total amount of guarantees given--abandoned the scheme after becoming disenchanted with it.

Claims paid out over the period 1970-80 were reported to be ₵1.1 million, or 0.5% of the total amount of guarantees issued in that period. Such a low payout rate over a 10 year period of great economic difficulty raises questions about the operation of the scheme. An explanation could be that the administrators of the fund were slow in paying out claims, a complaint made by some of the participating banks.

Evaluation of the Scheme. The Ghana Credit Guarantee Scheme suffered from two kinds of problems. First, it failed to increase the cedi limit on amounts guaranteed so as to reflect inflation and real costs more accurately. Participating banks did suggest in 1980-81 that the maximum value of investment defining a small enterprise should be raised to ₵300,000 and the liability of the CGS should be a straight 66-2/3% of the amount advanced, with no maximum of ₵50,000 imposed. The second problem pertained to settlement of claims. Participating banks claimed that the Credit Guarantee Scheme was reluctant to settle claims. They believe that the managers of CGS were under the misconception that the measure of success of a guarantee scheme was a low pay-out rate.

The Development Finance Department which administers the CGS within the Bank of Ghana saw the situation differently. They reported serious problems in two areas which they claim disrupted the operations of the CGS: (i) participating banks submitted doubtful loan accounts for coverage under the CGS and then tried to invoke the guarantees quickly, and (ii) once the CGS paid out claims the banks did not pursue recovery of any part of these funds from their defaulting clients. According to the regulations, CGS had the right to refuse applications for guarantees for borrowers with deficient accounts. In practice, the CGS did not exercise the right of refusal since it did not have the staff necessary nor access to information to properly assess the applications. During the 1980-84 period the participating banks evidently did not find it financially worth their while to pursue small borrowers in default.

LIBERIA

A Credit Guarantee Scheme was set up at the National Bank of Liberia (NBL) in 1979 to provide a degree of protection to commercial banks and credit institutions against possible losses on loans and advances. It was hoped that this would lead to an increase in the volume of institutional finance to small and medium business enterprises owned by Liberians.

Eligibility. In order to be eligible for a guarantee, advances have to satisfy the following conditions:

- (a) they must be granted to Liberian individuals or to organizations wholly owned by Liberians;
- (b) they must be granted to enterprises engaged in agriculture and industry (excluding the entertainment industry) and utilized for acquiring fixed assets or for working capital;
- (c) they must not exceed L\$100,000 to a single borrower, or L\$250,000 to a group of related interests where a borrower trades under different business names or has substantial holdings in more than one enterprise.

Guarantee Fee. The guarantee fee is 1% per annum. The fee is determined on the maximum amount of the advance as approved for the first year; for subsequent years the charge is calculated on the outstanding loan amount. There is currently (March 1986) a proposal to increase the fee to 2% per annum.

Risk Sharing. The scheme provides for reimbursement of 66-2/3% of the amount in default (including principal and interest) or the amount guaranteed, whichever is less. In the case of advances granted under any special scheme (such as IDA credit, etc.), the extent of guarantee cover may differ from this figure.

Funding of the Scheme. The guarantee scheme was started with an initial funding of L\$500,000. By January 1986 this fund had been reduced to around L\$206,000 through payment on claims. A promise by the government to increase the fund to L\$1,000,000 had not materialized by January 1986.

Claims Procedure. The conditions to be complied with before a claim can be invoked by a credit institution are: (1) the guarantor must be informed of said default as soon as possible and in any case not later than 15 days after the date of expiry of the guarantee; and (2) the credit institution must furnish a certificate to the guarantor to the effect that the borrowing unit and the sureties, if any, have been called upon to pay to the full extent of their liability and that the amount in default cannot be realized without resorting to legal remedies.

Operation of the Scheme. The scheme, which was still in operation in early 1986, has performed poorly since its inception. By early 1986 NBL's exposure on guarantees issued was L\$997,000. Confidence in the scheme was low, and commercial banks were skeptical about receiving payment after they filed claims. There have been complaints that the instructions given by NBL were unclear, resulting in confusion and misunderstandings. Another complaint has been that the process of making a claim is lengthy and tedious. The Liberian Bank for Development and Industry (LBDI) was recently engaged in a dispute with NBL on the settlement of claims. LBDI wanted NBL to pay the guaranteed amount as soon as legal proceedings for recovery of debt are initiated. NBL's position was that all remedies, including legal proceedings, had to be exhausted before settlement of a claim. When NBL finally agreed to settle the dispute with LBDI, it proposed to do so by taking personal guarantees from the defaulters before paying out the claims. For the period January to December 1985, total guarantees in the amount of L\$206,344 were invoked by LBDI. NBL paid to the extent of 66-2/3% on an aggregate amount of L\$118,240. For the same period, guarantees amounting to L\$344,762 were revoked by NBL because of non-payment of guarantee fees by LBDI.

MOROCCO

The Caisse Centrale de Garantie (CCG) set up in Morocco in the early 1970s provides a government guarantee for eligible loans and supplier credits to Moroccan enterprises. A committee with members from the Ministry of Finance, the Bank of Morocco and the technical ministries concerned is responsible for reviewing guarantee applications. The committee meets five or six times a year to review a dozen or so applications and is chaired by the Director of the Treasury, who also serves as managing director of the CCG.

Guarantee Fee. The guarantee fee charged to the credit institution varies according to the term of the guaranteed loan. The fee structure is presented below.

Below 5 years	1.25%
Between 5 and 7 years	1.80%
Between 7 and 9 years	2.25%
Between 9 and 12 years	3.25%

Claims Procedure. A loan must be in default for two years before the guarantee can be invoked. Also, before invoking the guarantee, the credit institution must demonstrate it has made all reasonable efforts to collect on the defaulted loan.

A major problem that requires immediate attention is that CCG cannot meet its obligations. There is no guarantee fund and therefore the government must settle claims. As of August 31, 1983, CCG owed more than DH 163 million on local and foreign loan. No action on these obligations has been taken. CCG's own resources fall short of meeting even its administrative needs. Payments on claims are decided on an ad hoc basis by the Treasury.

Other problems are poor evaluation criteria and the limited and poorly qualified staff. CCG has only five professionals, who are unable to properly appraise guarantee applications, and there are no clearly specified eligibility criteria for guarantees.

Due to lack of staff, large parts of the fees due remain unpaid. Unpaid fees at the end of 1982 amounted to 154% of those paid in 1981 (DH 50 million).

Tables showing the total guarantees given and the sectoral breakdown are given below:

	<u>December 31, 1981</u>	<u>December 31, 1982</u>
	<u>(DH million)</u>	
Total guarantees	8,334	9,593
of which: foreign exchange	4,388	4,106
dirhams	3,946	5,487
Public sector	6,364	6,151
Private sector	1,970	3,442

The sectoral distribution of CCG guarantees was as follows at December 31, 1982:

	<u>Public Sector</u>	<u>Private Sector</u>
	<u>(DH million)</u>	
Energy	1,765	-
Mining	384	-
Communications	1,820	-
Fisheries	1	1,899
Agriculture	480	75
Industry	1,701	1,191
SME	-	277
<u>Total</u>	<u>6,151</u>	<u>3,442</u>

6.33 Among the reforms recommended for CCG by a World Bank mission in 1984 were these:

- (1) CCG's current financial position must be strengthened by a treasury grant to create a fund to give CCG a sound financial base. Past claims must be separated from new commitments in CCG's accounts and funds for settling past claims must be made available.
- (2) CCG's commissions should be set at a level that enable CCG to meet reasonable operating costs. A reasonable fee level would also discourage recourse to CCG guarantees where there is no need for them.

- (3) CCG's guarantee cover should be reduced from 80% to 60% of the loan for the project appraised. The current guarantee, which may be 100% and unconditional, increases the risk that financial institutions will relax their appraisal criteria and transfer the entire risk of projects to CCG.
- (4) A total annual limit on CCG commitments should be set, taking into account the resources available and the quality of the loans guaranteed.
- (5) Payment of claims should be accelerated through faster processing by CCG.
- (6) CCG should hire enough qualified staff members to develop adequate appraisal capability.

TUNISIA

A guarantee fund, the Fond National de Garantie (FNG), was established by law in Tunisia on December 31, 1981. The law provides for guarantees for small and medium agricultural, industrial, and artisanal production units,^{11/} primarily in connection with credits to finance the establishment of new units or the expansion of existing units and their export operations.

Risk Sharing. The FNG guarantees between 50 and 75% of the outstanding principal of such loans. The guarantee covers 75% of the loan amount if the loan is less than 10,000 dinars and 50% of the loan if it exceeds 10,000 dinars. The banks making the loans assume the rest of the risk.

Funding of the Scheme. The FNG derives its funds from the following sources:

- (a) a 5/8% levy on short-term bank overdrafts not representing rediscountable credits;
- (b) a one-time levy of 1/8% on investment loans not eligible for an FNG guarantee granted by banks out of their equity resources to non-agricultural sectors, and a 1/8% one-time levy on the total amount of guarantee credit backed by the beneficiaries of such guarantees.

Claims Procedure. A guarantee can be invoked two years after a loan is in default. Before invoking the guarantee, however, the institution must demonstrate that it has taken all reasonable efforts to collect on the defaulted loan.

Operation of the Scheme. Since FNG only began its activities in 1982, it is too soon to make a reasoned judgment on the appropriate commission rate to be paid by beneficiaries of guaranteed credits.

Also, FNG's sphere of activity is limited to small- and medium enterprises. The percentage coverage given by FNG guarantees to these beneficiaries is often considered too low by these, and they complain of the additional collateral requirements of banks for the portion of the credit not covered by FNG. At the same time, there is a risk in increasing the coverage without a consideration of the bank and beneficiaries attitude towards recovery.

As of May 1986, there were no claims against the FNG although it was expected that there may be a number of such claims towards the end of 1986 when the two-year waiting period expires. The FNG has not been widely used by the commercial banks.

^{11/} According to the Tunisian definition, small and medium enterprises are those in which up to 500,000 dinars has been invested. A proposal to increase this ceiling is under consideration.

CHAPTER 7

LATIN AMERICA AND THE CARIBBEAN

BARBADOS

The Central Bank of Barbados, in an effort to promote the growth of the small business sector, introduced a credit guarantee scheme for small businesses in September 1979. The Central Bank Act (Amendment 1977) authorized the Central Bank to operate and fund the scheme, and the Credit Insurance and Guarantee Department of the bank was entrusted with the responsibility for its administration. The object of the scheme is to enable small businesses to obtain finance from commercial banks and other credit institutions without having to provide security from their own sources. The commercial banks are responsible for evaluating project proposals and submitting the necessary applications to the Central Bank. These applications are reviewed by the Central Bank primarily to ensure that the terms and conditions of the scheme have been complied with. A bank's assessment is generally accepted by the Central Bank without further detailed investigation. Commercial banks are required to notify the Central Bank, on a monthly basis, of any applications that are rejected.

Eligibility. To be eligible for a credit guarantee, the borrower must qualify as a small business borrower in one of the following categories:

- (a) An agricultural enterprise which meets any two of the criteria listed below:
 - (i) Total capital - less than BDS\$100,000;
 - (ii) Acreage available for cultivation - not more than 25 acres;
 - (iii) Annual sales - less than BDS\$300,000;
 - (iv) Number of employees - less than 25 persons.

- (b) An enterprise engaged in manufacturing, retail trade, construction, hotel industry, or catering which meets any two of the criteria listed below:
 - (i) Total capital - less than BDS\$100,000;
 - (ii) Annual sales (or value of completed contracts in the case of construction enterprises) - less than BDS\$500,000;
 - (iii) Number of employees - less than 36 persons.

- (c) An enterprise engaged in transportation which:
 - (i) owns vehicles with total original cost of less than BDS\$250,000; and
 - (ii) has annual receipts of less than BDS\$150,000.

- (d) An enterprise engaged in medical, health or educational services which:
 - (i) owns fixed assets and equipment with total original cost of less than BDS\$100,000; and
 - (ii) has annual receipts of less than BDS\$250,000.
- (e) An enterprise engaged in other professional services which
 - (i) has annual receipts of less than BDS\$100,000.

The guarantee limits are BDS\$50,000 for credit in excess of one year (mostly for fixed assets) and BDS\$25,000 for credit facilities granted for one year or less (mostly working capital). Guarantees are not granted for periods in excess of the useful life of an asset acquired, and in no case will a guarantee be granted for a period in excess of 10 years.

Guarantee Fee. The commercial banks are charged a fee of 1% per annum, payable quarterly, based on the highest outstanding amount of the guarantee during the quarter. The banks are allowed a spread of 3% to 3.5% for such guaranteed loans over and above the bank rate, which includes the one percent guarantee fee. The spread of 3% is for guarantees granted for one year or less, while the 3.5% spread is applicable to longer term guaranteed loans.

Risk Sharing. All advances made under a guarantee are covered. The risk sharing between the guarantee institution and the commercial bank is 80% to 20% for guarantees of one year or less and 70% to 30% for guarantees of over one year. The guarantee covers both borrower insolvency and protracted default.

Funding of the Scheme. The Central Bank Act authorized the Central Bank to operate and fund the Credit Guarantee Scheme. The scheme is backed by a special fund created out of the Central Bank's profits. At the end of 1980 the funding for the scheme was BDS\$300,000. The scheme's maximum liability was fixed by the Central Bank's board of directors at 10 times the amount of the fund (i.e., BDS\$3.0 million in 1980).

Operation of the Scheme. Within the first year of operation (1980), 14 guarantees were issued on behalf of 10 small businesses to four banks operating locally. Of the 14 guarantees, 5 were for one year or less. The liability coverage ranged from BDS\$3,200 to BDS\$22,400. The remaining 9 guarantees were for periods of more than one year, and maximum liability coverage ranged from BDS\$4,000 to BDS\$20,000. Small manufacturing operations, retail operations, auto mechanics, handicrafts, and stereo assembly were among the small businesses that took advantage of the guarantee facility. In most cases, credit guarantees were used as additional security and did not replace collateral.

Evaluation of the Scheme. The Central Bank has gone a long way towards simplifying its application forms and procedures and reducing

record-keeping by the commercial banks. Despite these efforts, the commercial banks have not been very receptive to the scheme, and only four of the seven local banks have participated in it. Even when the guarantee was used, this was done only to give additional security to the collateral provided. It is almost certain that no additional funds to small businesses were generated by the scheme. Some banks, even though they gave a commitment to participate in the scheme, have consistently turned away potential users of the scheme by claiming ignorance of how it works. This attitude is primarily due to the fact that the commercial banks regard the scheme as a way of making them approve loans to very risky small businesses. In addition, the commercial banks are not very enthusiastic about granting small loans on which the risks are high and the profitability is low. They prefer to make larger loans where the risks are high but the profitability is higher.

The commercial banks also felt that lending to small businesses was administratively too costly. Obtaining guarantees only made the administrative problems worse, they claimed.

Many of the credit officers of the commercial banks lack experience in lending to small business and therefore avoid making such loans even with the guarantee. Even if the credit guarantee scheme assumed 100% of the risk, it is doubtful whether this would significantly increase the use of the scheme, since commercial bank managers believe that it would show poor judgement on their part if too many claims were made. Small businessmen initially welcomed the scheme, but that early optimism soon disappeared. They are now of the opinion that the scheme will be of little help unless the Central Bank is given special powers to force the commercial banks to use the scheme. The Central Bank of Barbados, while realizing the limited effectiveness of the scheme, still believes that it can play a positive role.

COLOMBIA

A credit guarantee fund under the title Fondo Nacional de Garantia (FNG) started operating in Colombia in January 1983. The FNG was originally established by Instituto de Fomento Industrial (IFI) and Corporacion Financiera Popular (CFP) in 1981. Later, PROEXPRO (the Export Promotion Organization), CARBOCOL (a national mining corporation), and ACOPI (Association of Colombian Small Industries) also became shareholders. FNG's total paid-in capital amounts to Colombian pesos 100 million (around US\$0.52 million in mid-1986).

Eligibility. Eligible for guarantees are loans to legally constituted firms with up to 80% local ownership and assets below 100 million pesos (US\$520,000 approximate in June 1986). Such firms receiving guarantees should not have sales above Col\$150 million (US\$780,000) and employ less than 150 workers.

Guarantees are provided through a certificate of guarantee for loans for construction, for purchase and installation of equipment, and for working capital.

Guarantee Fee. The guarantee fee charged is 2% per annum, based on the guaranteed portion of the loan (the fee is payable at the beginning of the year).

Risk Sharing. The guarantee originally covered 80% of the loan amount. In 1986 this was changed and in some cases the FNG can guarantee up to 100% of the loan. The maximum value of a guarantee certificate in June 1986 was Col\$6 million (approximately US\$31,250) and the minimum value was set at Col\$100,000 (approximately US\$520). Guarantee certificates can be renewed yearly.

Claims and Procedure. In the event of a default in payment, the financial institution that made the loan can claim reimbursement up to the amount of the guarantee certificate, but only after it has recovered the maximum amount possible from the available securities and collateral. The repayment by FNG would then be reduced by the amount recovered. The FNG would then accept the obligation to pay up to the value of the guarantee certificate (after allowing for amount recovered) within 30 working days.

In the first years of operation, the FNG decided on a special manner of payment of claims. For certificates of guarantee between Col\$100,000-500,000, the amount were paid out in full immediately. When the amount remaining to be paid on the guarantee certificate is between Col\$500,000 and Col\$1 million, the fund is reimbursed up to 75% immediately. When the amount covered by the guarantee certificate is between Col\$1 million and Col\$2 million the fund paid out only 50% of the value of the certificate, and when between Col\$2 million and Col\$4 million the fund limited its payment to 25%. In practice, this means that the fund made a maximum first payment of Col\$1 million, irrespective of the size of the guarantee. The remainder of the amount owed under the guarantee certificate would be paid out when the financial institution demonstrated

that it had taken legal proceedings against the defaulter and when it can show that the debtor has been declared in bankruptcy. The guarantee certificate only covers principal. The FNG does not reimburse loss of interest, nor legal or collection costs. Since early 1986 the FNG has changed its manner of paying out claims. 50% is now paid out immediately on receipt of the claim and the remaining 50% within 90 days after evidence that the financial intermediary has taken steps to foreclose on the borrowers. Guarantees up to Col\$500,000 are still paid out in full immediately.

Operation of the Scheme. The first guarantees were given out in March 1983. By the end of December 1983, 316 requests for guarantees had been received, of which 276 were approved, 20 were denied and 20 were being studied. The total value of the guaranteed amount was Col\$112.6 million (approximately US\$1.2 million). By end April 1986 the number of approved guarantees reached 1065 for a total amount of Col\$1,132 million (approximately US\$5.86 million).

The FNG is run by a staff of around 20 persons from one office in Bogota. Although steps were taken to try to establish branch offices in main towns, it was found that this was not justified economically. Of the guarantees given out in the first 9 months, 44% of the clients were in Bogota, the capital, and 27% were in Cali.

As of April 1986, FNG had paid out 117 claims to CFP for a total amount of Col\$38 million (about US\$210,000). Although the FNG was available to all institutions in the banking system to end 1985, 70% ^{12/} of the guarantees given out were for loans given out by the Corporation Financiera Popular (CFP), the government-owned development bank for small and medium enterprises. The FNG is making efforts to get requests for guarantees from commercial banks to use the guarantee scheme.

There have been complaints of delays in obtaining approval for guarantees from FNG. One recent study ^{13/} of CFP's subproject processing time shows that it takes, on average, a total of 165 days to process a subloan and of this 52.5 days were taken to obtain the guarantee. However, it is claimed by FNG that since early 1986 a reorganization has reduced this time to no more than 3 weeks.

^{12/} This figure dropped to 59% in the first five months of 1986.

^{13/} By ACOPI - Association of Colombian Small Industries.

HAITI

In Haiti an Industrial Development Fund (IDF) was set up in early 1983 under the board of directors of the Central Bank of the Republic of Haiti. The objective of the fund was to provide credit and guarantees to productive private enterprises. The fund is supposed to administer two basic operations: (1) discounting of loans, and (2) guarantees for loans to priority industrial subsectors. The fund was expected to be self-supporting. IDF credits were to be offered through participating financial intermediaries, mostly commercial banks.

Eligibility. Registered small and medium-sized enterprises which are 51% owned and controlled by Haitian citizens, and operating in handicrafts, manufacturing, agro-industry, fisheries, mining, tourism, transport, industrial construction, or ancillary services related to such subsectors are eligible to receive guarantees. Eligible enterprises must meet the following criteria:

- (1) be receiving a discount operation of G 1,250,000 or less;
- (2) have a maximum debt/equity ratio of 3:1;
- (3) have an estimated debt-service coverage ratio of at least 2:1;
- (4) have no overdue financial obligations.

Participation. All financial intermediaries in good standing with the Bank of the Republic of Haiti qualify to participate. However, a financial intermediary with portfolios affected by arrears of more than 25% is not eligible to participate. It will have access to such operations only after reducing arrears to less than 25%.

Guarantee Fee. IDF charges a guarantee fee of 2% per annum on the guaranteed portion of the outstanding loan, payable on the anniversary date of the loan.

Risk Sharing. For discount operations up to G 500,000 the risk covered is 75%, while for discount operations of larger amounts (i.e., between G 500,000 - G 1,250,000), the risk covered is 60%. It should be noted that the guarantees cover only the risk of non-payment of outstanding principal, not of interest due. The interest spread allowed to a participating intermediary is 6% for discount operations up to G 500,000 and 5% for discount operations in the G 500,000 - G 1,250,000 range.

Funding of the Scheme. IDF was funded from resources made available by the government, resources from other national or international agencies, and from any net operating revenue.

Claims Procedure. Participating intermediaries are responsible for periodically reporting to IDF the status of their loans and, in particular, loans which are delinquent - that is, more than 30 days overdue in payment. IDF then examines each delinquent account and confers with the participating intermediary on the action to be taken. IDF will consider

claims under the guarantee scheme only after a loan is 90 days or more overdue, except in cases where the enterprise involved is declared bankrupt or dissolved. The participating intermediary must file a claim for payment not earlier than 90 days and not later than 120 days after the repayment falls due; otherwise, the guarantee is invalidated. A claim request must contain information on the actions taken and follow-up during the delinquency period, financial conditions of the enterprise, expected recovery, and proof that the participating intermediary has initiated legal proceedings against the delinquent client. According to the policy statement, IDF will settle such claims within 30 days from the date received. However, the participating intermediary is required to continue collection efforts against the defaulted borrower.

Any sums recovered will first be used to defray legal and collection costs incurred by the lending institution and/or the IDF and will then be distributed between the lender and the IDF in appropriate proportions. In the event collection efforts are unsuccessful and further attempts appear unwarranted, the participating institution will confer with IDF on when to suspend collection efforts. In such instances, IDF will write off the outstanding balance.

Operation of the Scheme. Through the end of 1983, only four projects took advantage of the guarantee scheme. In all cases, however, the guarantee was used only as added protection for the intermediary, since the loans were well collateralized. (In one case the fixed assets offered as collateral were several times the value of the loan itself.) So far, there is no evidence that additional lending has taken place because of the existence of the guarantee scheme.

Evaluation of the Scheme. The commercial banks have shown little confidence in the guarantee scheme and are continuing to lend only to well established clients who can provide collateral. They consider lending to other small clients as very risky even with the guarantee. They point out that the guarantee does not cover 100% of the risk and also that the guarantee applies only to the principal. They also fear that they would have to wait for a long time before they are able to collect on a guarantee in the event of a default.

JAMAICA

Until 1982, a credit guarantee scheme was administered by the Premier Investment Corporation (PIC), which was operated as a subsidiary of the Bank of Jamaica (BOJ). In 1981, political changes took place in Jamaica, as a result of which existing credit operations - including PIC - were closed down. A new institution called the National Development Bank (NDB) was then created to replace the previous institutions.

After some revisions, the earlier scheme had provided for the Bank of Jamaica through PIC to guarantee up to 50% of the amount of a loan against a one time fee of 2% to be paid by the borrower. The maximum guarantee per loan was originally the equivalent of US\$20,000, but this was later raised to US\$50,000 or 50% of any loan eligible for rediscount under the PIC scheme, whichever was lower.

According to reports, the credit guarantee scheme was not very successful in that the five commercial banks in the country did not give it real support, claiming that they did not trust the Central Bank (BOJ) to redeem guarantees. In an interview conducted in 1984, the largest commercial bank participants in the program stated that the guarantee scheme, even after the revisions, had not been a decisive factor in their making loans. One reason the banks gave for not believing that the guarantee scheme would pay any claims was that the Central Bank already owed the banks about \$40 million for claims under another scheme, the Export Development Fund.

Another reason given for the failure of the scheme was that the proof required of the commercial banks to show that they had made their best efforts to collect on delinquent loans was too stringent. The objective of the scheme--to create additionality of funds available to small firms--was thwarted by the banks' requiring very high collateral in spite of the guarantees.

USAID-SPONSORED GUARANTEE PROGRAMS

These programs were initiated in 1975 under the 1974 Amendment to the US Foreign Assistance Act of 1961, which authorized US assistance to small business guarantee programs abroad. In all, US\$12 million was authorized by USAID under the Productive Credit Guarantee Program (PCGP) for a guarantee authority for four Latin American countries--Paraguay (\$3.5 million) Costa Rica and Nicaragua (\$3.0 million each), and Bolivia (\$2.5 million). The programs initiated in Paraguay, Bolivia, and Costa Rica were designed to guarantee private loans, i.e., from commercial banks to small enterprises. The most developed scheme was implemented in Paraguay. By 1983, however, all schemes under the PCGP were discontinued due to disagreements between USAID and the governments as to whether all conditions for reimbursement of claims had been met. Total guarantees given under the PCGP schemes amounted to \$23 million. USAID paid out US\$100,000 to settle claims.

The scheme in Nicaragua, introduced in 1978, differed in various way from the other schemes. The Nicaraguan government made an equivalent contribution of US\$3 million to the Fund. Small-scale enterprises with total assets up to US\$33,000 and without enough collateral were eligible to apply for the guarantee. The loan was not to exceed US\$25,000 and the guarantee covered 75% of the principal amount of the outstanding and up to 120 days of interest. Financial institutions could invoke the guarantee after a loan was in arrears for 120 days. The front-end fee was 3% of the loan, and a small annual payment was levied on the guaranteed portion. The scheme became operational, guaranteeing over 300 loans through various banks, but collapsed because of political changes in 1979 before handling any claims. The majority of the loans guaranteed by the fund had a repayment period of between 3-5 years. The average amount guaranteed per loan was approximately US\$6,000. For the entire period that the scheme was in operation there was only one case of no repayment by the borrower, and arrears were below 1% of the total portfolio, but the scheme was in operation for too short a period to obtain a true picture of the viability of the scheme.

The programs in the other countries--Paraguay, Costa Rica, Bolivia--provided government guarantees to motivate lending institutions to make loans to small enterprises and made the services of private consultants simultaneously available to small businesses under the supervision of a government agency. The aim was to widen the access of small business and small farmers to institutional finance to reduce their dependence upon high-cost money lenders. It was expected that small business would be assisted in obtaining these loans despite more stringent procedural requirements through the availability of consulting staff, who would assist in preparing and evaluating projects for a fee of 3 to 4% of the value of the loan. The consultants were expected to provide follow up assistance, if required, at reasonable rates. The effective cost of the loans, including the guarantee premium and the support assistance, was 16% or 17% per annum, which was still much lower than other sources of finance for small business.

Eligibility. In order to be eligible for guarantees, borrowers by and large were expected to be businesses employing less than ten workers and requiring less than US\$50,000 in credit (the limit was US\$25,000 for enterprises owned by individuals).

Guarantee Fee. A one-time fee of 5% was charged for the guarantee. An unusual feature was that the 5% premium was charged on the total loan amount, and not on the guaranteed portion only. The programs were intended to be self-supporting out of revenue generated by the 5% guarantee fee plus some initial administrative support donated by the Central Banks administering these programs. Training, manuals, and advisory service were contributed by USAID. Data available did not permit full actuarial assessment of the probable range of defaults, but some general calculations indicated that a 5% premium would cover the likely losses from defaults.

Risk Sharing. The risk covered by the scheme was 75% of the loan, with 50% covered by US AID and 25% by the banks collectively. The lending institution then was responsible for the remaining 25% of the risk. It was hoped that the 75% guarantee, along with lending rates ranging from 8 to 14% and a plan to allow discounting the guarantee portions at 6% (which never materialized), would make lending to small enterprises financially attractive.

Claims Procedure. The guaranteed part of the loan was to be paid from the Productive Credit Guarantee Program (PCGP) fund within 30 days after a default period of 180 days.

Operation of the Schemes. Total lending under the three programs (Costa Rica, Paraguay, Bolivia) in the period 1978-80 amounted to \$16 million in loans averaging around US\$120,000 each. Repayment periods averaged five years. In Costa Rica, the Productive Credit Guarantee Program started operations in January 1979. In the agreement it was laid down that the credit guarantee system would have the capacity to guarantee a total portfolio of loans equal to US\$6.0 million. AID's assistance would consist of a guarantee of US\$3.0 million. It seems that the size of the guarantee portfolio was dictated more by the availability of funds for lending than by the amount of the guarantee fund. The amount approved for guarantees during 1980 was equal to US\$1.1 million, against an original projection for that year of US\$2.4 million. The projection for the whole five-year program was US\$24.4 million. After one year's operation of the scheme in Costa Rica, the results were considered acceptable in three of the four banks that participated in the system. However, due to problems in the fourth bank, which alone accounted for 59% of the total amount approved, 19% of all guaranteed loans in the scheme were more than 90 days in arrears by 1981. The problem seemed to arise from inadequate supervision and poor project evaluation. The technical assistance seems to have been carried out by inexperienced consultants. The bank with the problems was suspended from the system for surpassing the allowed percentage of bad debts. The whole scheme was discontinued in 1982.

The credit guarantee program in Paraguay grew rapidly, surpassing initial projections. The Central Bank of Paraguay reported that during the initial 15 months, 534 guaranteed loans were made for a total amount of US\$9.9 million. During a review in October 1980, complaints were made about the quality of projects approved for guarantees, about the work of the consultants, and about the supervision of the Central Bank. Lending was suspended in 1981 due to the non-availability of further funds for making loans, but not before some controversy had arisen about the payment of some claims. The Central Bank refused to pay on grounds that the lending banks had not taken adequate precautions in approving the loans. By that time, total guarantees amounted to US\$17.5 million.

The PCGP in Bolivia never developed into a large program, although some very small loans were given out to small scale farmers under the scheme before it was discontinued in 1983.

The PCGP suffered in all the countries in that the scheme provided only guarantees and not the actual financing of loans. Shortage of funds for lending became a constraint.

Although the Productive Credit Guarantee Program more or less ceased to operate after 1982, another department of USAID, the Bureau of Private Enterprise, set up in 1981, has revived the idea of USAID financing of guarantees for loans made by commercial banks for small-scale enterprise. Such guarantee funds have been set up recently (1984-85) in a few countries (Thailand, Morocco), but they have not been in operation long enough to draw any conclusions.

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