European Union

European Agency for Reconstruction

Government of Montenegro

Directorate for SME Development

WORKSHOP ON
CREDIT GUARANTEE FUNDS

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Credit Guarantees: Risks and Supervision

Advisory Support for Transformation of the Development Fund
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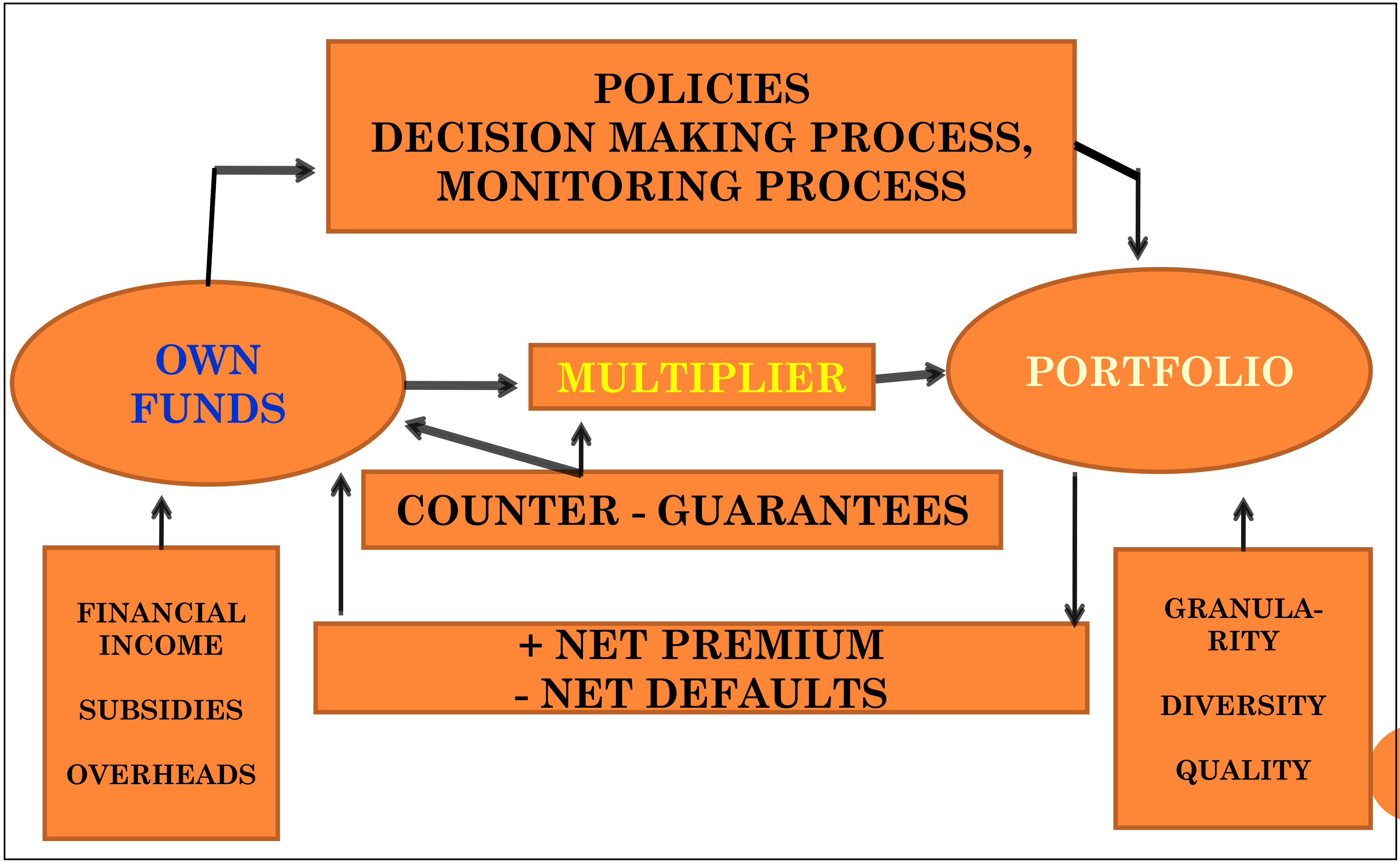
THE "GUARANTEE ENGINE"



RISK MANAGEMENT

- Credit risk
- Operational risk
- Liquidity risk

SUSTAINABILITY

- Political risk

CREDIBILITY

Individual risks

-Guarantor (owner, sponsor)
-Lender (bank, leasing,)
-Borrower (entrepreneur)

Collective risks

-Public sector
-Banking system
-SME access to credit

ENSURING SUSTAINABILITY AND CREDIBILITY

- **SUSTAINABILITY = CAPACITY TO PROTECT AND TO DEVELOP OWN FUNDS IN THE LONG TERM IN A GIVEN ENVIRONMENT**

  "Social orientation", but not at the cost of tax payers

  → **sufficient capitalization**

  → **sound policies**

  → **sound management**

- **CREDIBILITY = INSERT THE INSTRUMENT WITHIN THE COUNTRY'S FINANCIAL STRUCTURE**

  → **know each other's and co-operate fairly**

  → **learning process**

  → **external control: supervision**

AVOIDING MORAL HAZARD AND SOLUTIONS

- **MORAL HAZARD leads to malpractice / abuse of the system by:**
  - **Borrowers:** loss of financial discipline, "run-away" effect → *They remain liable of the full repayment of the credit; the payment of default by a borrower does not offset their liability*
  - **Lenders:** no serious risk evaluation, no serious follow-up → *they bear a part of the final loss; the guarantor has a limited right to cancel his commitment (if no professional behavior)*
  - **Guarantor:** loss of sustainability, corrupted system… → *sound and professional management / no political interference*

CREDIT RISK: LOSS DUE TO DEFAULTING GUARANTEED BORROWERS

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BASEL 2 CAPITAL ADEQUACY RATIO: 6% IN THE SO CALLED "STANDARD APPROACH"

- **POLICIES** (*Board/Executive Committee*):
  - Definition of limits: *max amount, tenor, eligibility*
  - Portfolio: *multiplier, diversification (sector, region,..)*
  - Risk sharing: *downwards and upwards*
  - Premium : *commercial ? Or subsidized transaction ??*

- **OPERATIONS** (*Management*):
  - Assessment of applications: *added value to lender*
  - Portfolio monitoring *(individual and comprehensive*)
  - Bad debt management and recovery management
  - Controlling: internal + external auditor

CREDIT RISK: THE SPECIAL CASE OF AGRICULTURE

- First question: **agriculture or rural businesses**?
  (EU policies tend to move from agricultural to rural development)
- **Many CGF schemes** active in EU countries:
  - AVHGA Hungary: www.avhga.hu
  - Coldiretti Italy: www.coldiretti.it
  - SGFA Italy: www.figweb.it
  - Emès Ükio paskolu Garfondas Lithuania: www.garfondas.lt
  - Agrogarante Portugal: www.spgm.pt
  - RCGF Romania www.fcgr.ro
  - Belgium (Ministry), Latvia …

CREDIT RISK: SPECIAL FEATURES OF AGRICULTURAL CREDIT

- **SPECIAL RISKS**: ***weather, droughts, floods, price fluctuations***
- **MANAGEMENT ISSUES**:
  - **working capital needs** (bridging the gap "between seeds and crops") → ***short term loans***. Should a CGF ask for an insurance against natural disasters?
  - **modernization** (equipment to raise productivity) → ***investment loans (2 – 4 years duration)***
  - **tissue renewal** (succession) → longer investment loans
- **OTHER ACTIVITIES**:
  - Diversification in agriculture (rural tourism, valorization of output, etc…)
  - Rural businesses (craftsmen, tradesmen): making our villages and countryside lively and prosperous…
  - Rural infrastructure by municipalities: is an issue…

OPERATIONAL RISK = RISK OF LOSS FROM INADEQUATE OR FAILED INTERNAL PROCESSES/PEOPLE OR FROM EXTERNAL EVENTS AND LEGAL RISKS

- **EQUITY REQUIREMENTS (Basel 2):** 12% of the average 3 years of gross profit (in the so called "retail approach")

- **MANAGEMENT:**
  - Manual of procedures,
  - "Four eyes" principle,
  - Separation between "front" and "back" office,
  - Internal audit,
  - Training

LIQUIDITY RISK = RISK OF RUNNING OUT OF CASH (TEMPORARILY OR PERMANENTLY)

- **SIZE MATTERS**: larger CGF are less exposed to individual shocks
- **CASH MANAGEMENT**:
  - Profitability
  - Provisions, backed by highly liquid assets
  - Balanced financial management: liquidity vs. high financial return
  - Careful about the "interest rate risk"

POLITICAL RISK = THE RISK THAT THE CGF GETS FORGOTTEN IN THE SME "FINANCE CHAIN"

- **CGF CONSIDERED NOT RELIABLE**
  - ***Lack of supervision, of transparency, insufficient capitalization or exceeded acceptable leverage, too much additionality, policies changing all the time***

- **CGF IS NOT "MARKET RELEVANT"**
  - ***Not in line with local banking culture, no visibility, weak marketing, scheme does not properly address market failures / imperfections***

- **CGF IS NOT EFFECTIVE**
  - ***High access cost, products badly designed, fragmented guarantee networks***

- **CGF IS POLITICALLY NOT ACCEPTED**

CONTROLLING = SECURITY

- **SUPERVISION** = general framework ensuring that a CGF is properly managed and follows prudential rules related to its solvency, liquidity…
- **EXTERNAL AUDIT** = delivers an opinion on the quality of financial statements that are publicly disclosed ("unqualified" opinion, "qualified" opinion)
- **INTERNAL AUDIT** = assessment that internal procedures and policies are respected at the operational level

PRUDENTIAL SUPERVISION

The CGF being an independent body, with an autonomous decision making process, **supervision is the necessary condition** to create:

- **TRUST WITH OWNERS**: shareholders must be convinced that the scheme is properly managed: long term sustainability and no capital depletion

- **TRUST WITH LENDERS**: banks have the certainty to be fully and timely refunded for the proportion of the losses covered by the CGF (thus higher leverage)

- UK, Ireland: no supervision, no independent CGF!!

PRUDENTIAL SUPERVISION

- **VARIOUS APPROACHES REGARDING THE LEGAL FRAMEWORK**
  - ***Banking Law***: France, Germany, Czech Republic, Portugal, etc.
  - ***Specific Regulation***: Italy, Belgium, Spain, etc.
- **SOLUTION ADOPTED IN CRNA GORA**
  - ***Law on Banks***: introduces the concepts and confers powers to the Central Bank
  - ***Central Bank Regulation***: will set the key parameters regarding (i) minimum capital, (ii) licensing procedures (iii) maximum coverage, (iv) exposure limits, (v) maximum value of multiplier, etc..

Drafting still ongoing, but from what we know, parameters are in line with prevailing practice

THANK YOU FOR YOUR ATTENTION

WELCOME TO THE CGF FAMILY!!

GOOD LUCK AND AT YOUR DISPOSAL IN THE FUTURE

André Douette