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CREDIT GUARANTEE MECHANISM FOR MICRO, SMALL AND MEDIUM ENTERPRISES IN LESOTHO

Rural Financial Intermediation Program

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BACKGROUND

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MSME access to finance is structurally problematic, but particularly so in Lesotho

- Total **lending is modest**: M 1,500 million of which about M 800 million to business enterprises. Also, **distribution of lending is highly skewed**, with top 20 borrowers accounting for 38% of total (2007 data)

- Lending to MSME unlikely to exceed M 600 – 700 million, i.e. **a mere 5-6% of GDP** (lower than in Swaziland, Namibia and Botswana)

- Surveys indicate that **access to finance is a serious obstacle** to private firms (World Bank: 57% of Basotho-owned firms in 2006; MTICM: 42% of MSME in 2008)

BACKGROUND

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Inability to mobilize appropriate collateral is a major problem

➡ Pending the reform of the land regime, **agricultural land** is normally not accepted as a valid collateral and only urban property can be used as a guarantee

➡ Liens on goods purchased with loans are sometimes used, but this applies typically to **movable goods** and to clients with a sufficient track record

➡ In most cases, **cash collateral** is *de facto* a pre condition for accessing finance, and amounts are quite significant

The focus of the proposed project is precisely to alleviate collaterals requirements

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Problems are typically blamed upon bankers excessively conservative behavior, but a number of other factors are at play

- Lots of survivalist entrepreneurs, with **limited skills and capabilities** (also, signs of ‘herd instinct’, with too many people trying to do the same thing)

- Sometimes projects are **too complex and/or too large** to be effectively implemented

- **Inability/unwillingness to provide financial accounts**, which makes it difficult to assess the solidity of the business

These are structural weaknesses which cannot be cured with any financial engineering type of intervention

KEY CONCEPTS

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Credit Guarantee

➡ A credit guarantee is a commitment by a Credit Guarantee Scheme (CGS) (the ‘**guarantor**’) regarding the repayment of a loan received by an enterprise (the ‘**borrower**’) from a commercial bank (the ‘**lender**’).

➡ Credit guarantees can facilitate access to finance **only if they are accepted** as a valid substitute for other forms of collateral **by commercial banks**.

➡ In order to be recognized as a valid risk mitigating, a credit guarantee must display certain features. Nowadays, **Basel II criteria apply**.

KEY CONCEPTS

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➡ In particular, a credit guarantee must be **direct** (i.e. represent a direct claim of the lender on the guarantor), **explicit** (i.e. address a specific exposure), **unconditional** (i.e. its payment is not submitted to conditions that are not under the control of the lender), **irrevocable** (i.e. cannot be cancelled by the guarantor unless the lender has failed to fulfill its obligations), **explicitly documented** and **legally enforceable**.

➡ Although established precisely to alleviate commercial banks' risks, **credit guarantees typically do not cover the full value of loans**, in order to avoid 'moral hazard' and opportunistic behavior.

A system based on credit guarantees requires reconciling different and equally legitimate interests, it is not about "imposing" anything on banks or granting a 'free ride'

KEY CONCEPTS

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Credit Guarantee Schemes

➡ There are many different institutional models: some CGS were **established by governments**, some by the business community as **self help organizations**, some are **public private partnerships** (PPP) involving the government, the private sector and/or the banking community. In developing countries, **donors** also play a role

➡ **Legal forms** also vary: government agencies, cooperatives, mutual societies, foundations, corporate forms.

➡ Irrespective of their public, private or PPP nature, **CGS fulfill a social role and are not for profit entities**. Even when a corporate form is adopted, whatever profits maybe achieved, they are not distributed and are ploughed back into the scheme.

KEY CONCEPTS

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- CGS are subject to different licensing and supervision requirements, depending upon their nature. **Public CGS** are often established on the basis of specific legislation and are supervised by the relevant government bodies.

- **Private and PPP schemes** are typically regarded as non-bank financial institutions, and their establishment is subject to licensing and supervision from central banks or other financial sector regulators. The aim is to ensure that operations are in line with basic principles of financial prudence (minimum capital, provisioning, volume of activity, etc.).

There is no "one size fits all" solution, and CGS must be structured taking into account specific conditions, in order to ensure maximum independence and operational effectiveness

KEY CONCEPTS

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Special Aspects: Volume of Activity

➡ The volume of activity of a CGS is linked to its capital. The ratio between the capital (equity and reserves) and the total amount of guarantees issued is referred to as the '**multiplier**' (or 'leverage effect'). Its reciprocal is the 'solvency ratio' used in banking.

➡ In developed countries, CGS often extend guarantees for a value that is **6-7 times greater than their capital**, but there are cases of CGS with 'multipliers' of 10 or more.

➡ In developing countries, operating conditions are more difficult and it is **advisable to adopt low multipliers**, typically 3 to 5 times the value of capital. In some extreme cases, the multiplier is set equal to 1, but then this is akin to a 'cash collateral'.

KEY CONCEPTS

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Special Aspects: Why Licensing and Supervision?

➡ The credit guarantees issued by CGS impact on the **stability of the financial system**: if the CGS were unable to keep their promise to pay in case of default, banks might run into serious problems. Hence the need for supervision, to **ensure that operations are in line with basic principles of financial prudence**.

➡ Regulation typically involves minimum capital requirements, rules for provisioning, ceilings to the volume of guarantees that can be issued (the ‘multiplier’), reporting requirements.

➡ Supervision ensures the **credibility of CGS’ commitments** and allows banks **not to make provisions** on the portions of loans supported by a credit guarantee issued by a duly licensed and supervised CGS

KEY CONCEPTS

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Special Aspects: Self Sustainability

➡ Although not profit oriented, well managed CGS strive to achieve **financial self sustainability**.

➡ Two sources of income: (i) **financial income** (the capital is invested in low risk financial instruments, like T-bills), and (ii) **credit guarantee fees** (a percentage of the value guaranteed).

➡ Two sources of costs: (i) **operational costs** (staff, rents, etc.), and (ii) **payment of guarantees** (sooner or later, there will be defaults and the CGS must honor their guarantees).

➡ A well managed CGS is able to balance income and costs **in the medium – long term**.

PROPOSED STRUCTURE

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Salient Features of the Proposed New Credit Guarantee Mechanism (NCGM)

- **Separate legal entity** (not a government department or agency), with its own charter, capital, governing bodies.
- **Corporate form** (limited liability or joint stock company, not a company limited by guarantees).
- **Capital of M 50 million**, considering both (i) potential market, and (ii) need to achieve a critical mass for financial income
- **Government biggest contributor**, but participation from **private sector and banks** also to be sought as it reinforces independence.
- **Licensed and supervised by CBL** as non bank financial institution. **Multiplier not exceeding 3**.

PROPOSED STRUCTURE

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Salient Features of the Proposed New Credit Guarantee Mechanism (NCGM) - continued

- **Board of Directors** (decides on policy matters) and **Guarantee Committee** (decides on guarantees), both with substantial participation from private sector and banking industry.
- Providing **partial credit guarantees**, with 50% to 70% coverage, (principal only)
- Assisting both **short term and medium – long term lending** in **all sectors**
- **Timely payment** in case of default (conditional/not conditional upon the start of legal proceedings)
- **Small, low cost structure**, to achieve self sustainability

TARGET MARKETS

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Three Facilities, Targeting Different Market Segments

- **Small Enterprise Facility**: targeting firms in operations for at least 2 years, with turnover/total assets of less than M 3 million. Two 'sub facilities' devoted, respectively, to short term (ST) and medium-long term (MLT) loans.

- **Solidarity Groupings Facility**: serving SACCO, RSCG, village groups, etc. (basically a continuation of the CGF currently managed by the CBL). Covers both ST and MLT loans

- **Start-up Facility**: serving greenfield initiatives or newly established firms (in operations for less than 2 years). Covers both ST and MLT loans.

- Small Enterprise Facility accounting for **90% of resources**. The other two **5% each**.

TARGET MARKETS

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Proposed Terms and Conditions

Facilities	Max Value of Loans	Max Maturity of Loans	Level of Coverage	Guarantee Fee
Small Enterprise Facility - ST	1,000,000	12 months	50%	2.0%
Small Enterprise Facility - MLT	1,500,000	60 months	50%	2.5%
Solidarity Groupings Facility	50 - 100,000	60 months	60%	1.0%
Start Ups Facility	50 – 300,000	48 months	70%	4.0%

➡ Maximum value of loans **not exceeding 50% of turnover/assets**, in order to guard against excessively complex projects.

➡ Coverage applies to **final loss**, i.e. considering the realization of other assets.

➡ **Guarantee Fee additional to interest rate** (entrepreneurs obviously ask for cheap money, but the issue here is to facilitate access).

OPERATING MODALITIES

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General Principles

- Relations with commercial banks governed by **Framework Agreements**, spelling out respective rights and obligations and specifying procedures for monitoring of loans, handling of claims, etc.

- Issuance of guarantees contingent upon a **positive assessment from commercial bank**.

- Commercial banks also responsible for **monitoring loans** and for **recovery procedures**.

- User friendly approach, to **reduce the documentation** to be provided by MSME applicants.

OPERATING MODALITIES

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Issuance of Guarantee: No Objection Basis (loans below M 1,000,000, with exclusion of Start-Ups)

- MSME submits **loan application** to its bank.
- MSME is found **credit worthy** (good project and sponsor) **but not bankable**, due to lack of sufficient collateral.
- Bank checks fulfillment of eligibility criteria and **submits a request for credit guarantee** to the NCGM, with basic details and retains documentation on file.
- NCGM may ask to **inspect the documentation** kept by the bank to verify eligibility and/or to form its own idea about the application.
- **If NCGM does not object** within a specified period of time (say, one or two weeks), the guarantee is approved.
- Bank informs MSME, **signs the loan agreement and collects guarantee fee on behalf of NCGM**. Guarantee becomes effective.

OPERATING MODALITIES

Issuance of Guarantee: Double Decision Making (loans above M 1,000,000 and all Start-ups)

➡ Filing of loan application remains the same, and the bank must appraise the deal and submit the request to NCGM

➡ However, an **explicit positive decision from the NCGM is required** in order to issue the credit guarantee

➡ NCGM may wish to conduct **its own due diligence**, inspecting documentation but also carrying out field visits.

➡ Decision about the issuance of credit guarantee is made by the **Guarantee Committee**.

➡ Conditions for effectiveness remain the same (signing of loan agreement and collection of guarantee fee on behalf of NCGM).

OPERATING MODALITIES

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Handling of Claims

- Bank **timely informs** NCGM of the termination of a loan, and submits the **relevant documentation** (termination letter, track record of borrower, reason for termination, amount outstanding at termination, estimate of the value of the collateral and of the amount that could be recovered).

- If borrower does not repay within a certain period of time, **bank submits a claim to NCGM**. The value of the claim is: (outstanding amount - expected recovery) * coverage.

- NCGM has the right to **inspect the documentation and check the calculations**. If no objection is made, claim is accepted.

- Acceptance **may or may not be contingent** upon initiation of recovery procedures (to be specified in the Framework Agreement).

OPERATING MODALITIES

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Handling of Claims (continued)

➡ Within a specified period, NCGM makes a **provisional payment of the estimated final loss** (say, 80%).

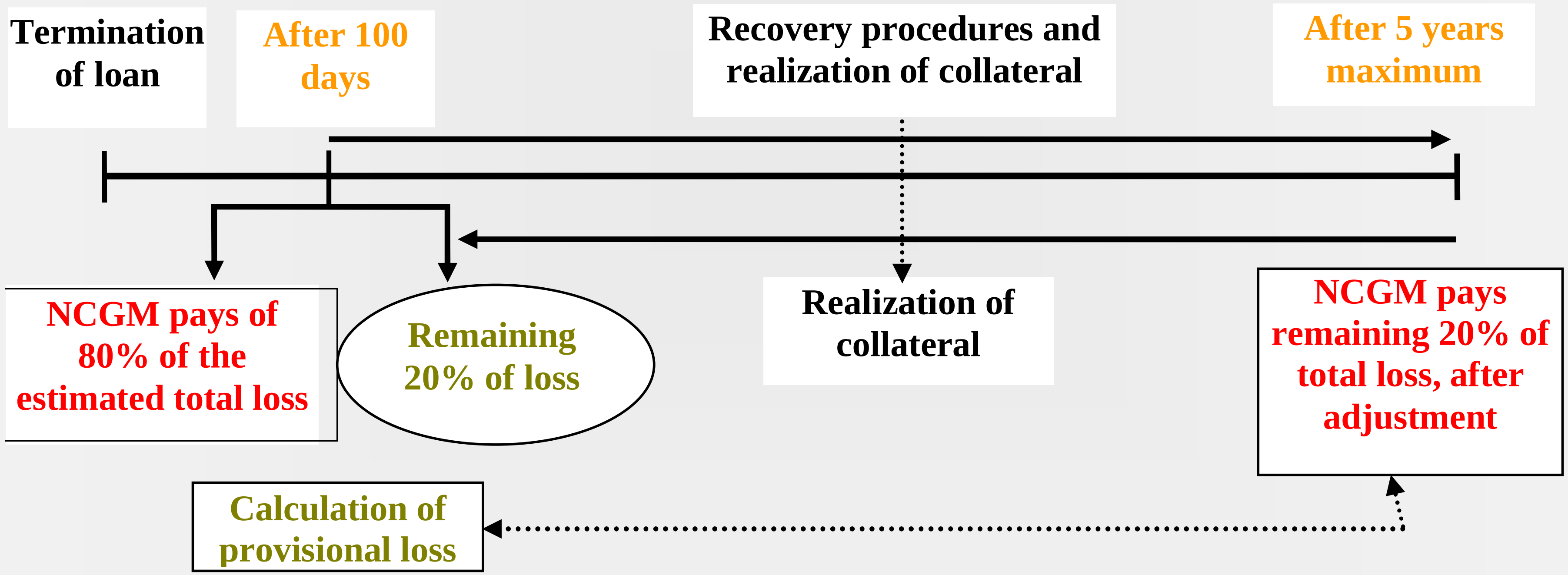
➡ Payment does not relieve the borrower from its obligations and the bank has the **obligation to proceed against the borrower** to recover due amounts, namely through realization of collateral. Bank is to look after NCGM's interest as it would be its own.

➡ At the end of the recovery procedure or after a certain maximum period of time has elapsed, **value of recovery is reassessed, and actual final loss is calculated**.

➡ NCGM **makes the final payment** on the basis of the actual final loss

OPERATING MODALITIES

Handling of Claims (concluded)



EXPECTED IMPACT & SUSTAINABILITY

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Business Plan & Financial Model covering 10 years

- Assumes a gradual take up, with maximum value of multiplier reached only in year 6.
- Assumes default rates in the 1.5% to 8% range (higher than current levels)

Item	Total	Small Enterprise Facility		Solidarity Groupings Facility	Start Ups Facility
		ST	MLT		
Number of Guarantees Issued	3,501	2,304	613	430	154
Value of Guarantees Issued*	877	606	239	19	13
Value of Loans Assisted*	1,740	1,211	479	32	18
Number of Jobs Created/Safeguarded**	19,129	12,111	6381	637	360

* M million, rounded figures. Totals may not add up due to rounding
** Estimate, based on rough parameters

EXPECTED IMPACT & SUSTAINABILITY

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Low Capitalization Scenario, also covering 10 years

- NCGM capital at M 30 million instead of M 50 million.
- Other assumptions remain unchanged

Item	Base Case Scenario	Low Capitalization Scenario
Number of Guarantees Issued	3,501	2,073
Value of Guarantees Issued*	877	519
Value of Loans Assisted*	1,740	1,031
Number of Jobs Created/Safeguarded**	19,129	11,332

* M million, rounded figures. Totals may not add up due to rounding
** Estimate, based on rough parameters

EXPECTED IMPACT & SUSTAINABILITY

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Financial Self Sustainability

- NCGM profitable throughout, with positive cash flow.
- Highly resilient, with good ability to weather adverse developments (modest losses).

Items	Y1	Y2	Y3	Y4	Y5	Y6	Y7	Y8	Y9	Y10
Total Income	3,238	3,922	4,679	5,499	6,347	7,284	7,597	7,892	8,235	8,597
Guarantees Paid Out & Provisions	2,007	2,755	3,569	4,448	5,237	6,253	4,908	5,023	5,287	5,527
Net Profit	397	360	296	234	331	326	2,051	2,282	2,379	2,531
Capital & Reserves	50,397	50,758	51,054	51,288	51,619	51,945	53,997	56,279	58,658	61.189
Net Cash Inflow	2,211	2,324	2,421	2,315	2,631	2,835	2,486	2,867	3,039	3,028

CONCLUSIONS

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Worth trying? Definitely yes!!

but

➡ **Credit guarantees are not a panacea: the NCGM will not (and should not!!) transform a lousy project/entrepreneur into a good one…**

➡ **Effective management will be essential and this will require professionalism and independence**

THANK YOU

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CREDIT GUARANTEE SCHEMES IN AFRICA

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Overview of existing CGS (by no means exhaustive …)