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DESIGN
Allcomm

PUBLISHER
Hilde Talloen

ISBN: 77-183
Date: 12/2002

# Guarantee Funds
## A Success Factor in Microfinance?

Kurt Moors and Geert Peetermans

A publication from the *Horizonten* series

# Foreword by Eddy Boutmans

*Development Cooperation is not the sole preserve of the government. More than anything else, our experience over the last few decades has taught us that the government and the private sector have a joint role to play in the fight against poverty. And so I am delighted by this guarantee fund initiative from the Belgian Raiffeisen Foundation and the Cera Foundation, which is wholly in line with the Fair Trade Guarantee Fund set up by the Belgian government.*

*As we can see from this book, the guarantee fund is an interesting financial instrument that allows people to take part in an economic process. However, the free market economy and globalisation are the dominant forces today. If the process of globalisation is allowed to develop without political guidance, the gulf between rich and poor will surely widen further. People running small farm holdings, along with ordinary workers, officials, and the organisations to which they belong, will be considered uncreditworthy and suffer further economic marginalisation.*



*The fight against poverty means more than promoting economic growth in the context of sustainability. If our development policy is to tackle poverty with any degree of success, it is important that we give people the opportunity to become involved in their own development. This means that economic growth must go hand in hand with the creation of sustainable employment, with healthcare and educational facilities, with promoting social organisations, with fair wages, and with concern for vulnerable groups. These are all aspects of a more social economy, one in which people are central, and yet one which pays due consideration to our planet's sustainable environmental limits.*

*A financial instrument that can offer people dignity and future prospects is well worth developing further, as I am sure you will agree. So I invite you to read on. Together, let us turn our thoughts to the issues that face us today, so that we can make guarantee funds even more of a success tomorrow.*

*Eddy Boutmans*
*Belgian State Secretary for Development Cooperation*

# Introduction

*This book was written in response to a seminar on guarantee funds organised by the Belgian Raiffeisen Foundation (BRS) in 2001. In theory, these funds appear to be a perfect financial instrument. When savings and credit organisations in developing countries approach commercial banks in their own countries, they are often unable to obtain credit. Generally, this is because they have little to offer in the way of collateral. In these cases, an external guarantee could help mobilise financial resources in the South. Over time, every guarantee fund expects to see a relationship of trust emerging between the savings and credit organisation and the local banking sector.*

*When we speak of "savings and credit organisations" in this book we refer to organisations in the microfinance sector whose services are aimed at the low-income populations of the South. In the first chapter we place this microfinance sector in context. Guarantee funds have been around for a great many years. In the second chapter we describe the various models to be found in the literature on this subject.*

*We find that guarantees do not work nearly as well in practice as the theories would have us believe. During the seminar, several organisations with practical experience were seeking answers to the main stumbling blocks. In the third chapter we take a closer look at their points of view regarding a number of core issues. We, the BRS, wish to take to heart these recommendations, and contribute actively by making available a guarantee fund. In the final chapter, you will find more details on this fund.*

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1

# MICROFINANCE: hope for the future for people in developing countries ?

## CONTEXT

The annual report of the World Bank informs us that 2.8 billion people, or almost half of the world's population, are living on less than 2 USD a day. No fewer than 1.2 billion people are living on less than 1 USD a day! Much hope, probably too much hope, has been pinned on the micro-finance sector as a means of redressing this inequality.

This chapter does not set out to give a full breakdown of the sector, which has many aspects. However, we wish to cover some of its major characteristics, which are important for gaining a better idea of the role played by guarantee funds later.

## BANKING: A QUESTION OF TRUST

The organisations that provide worldwide financial services are many and varied. They vary from traditional savings and credit groups (e.g. *tontines* or *roscas*[1]) to commercial banks with international outlets. In between, we find a number of other structures, such as associations, cooperatives, local credit institutions, village funds, development banks and non-government organisations.

Though these organisations may operate and organise themselves in many different ways, they are all focused on the same underlying concept - confidence. In essence, a financial institution should be a "place of trust". The bank plays the role of intermediary in a market driven by the supply of and demand for financial resources. And indeed, the people and organisations that provide these financial resources, in the form of savings or capital, trust that the bank will convert their money into loans and other investments safely.

In an ideal world, financial institutions would operate on the basis of trust and nothing else. In practice, every organisation puts procedures and resources in place to control, apply pressure to, and cover themselves against the risk of financial loss.



[1] A tontine (French) or rosca (English) is essentially a (temporary) group of people whose members regularly contribute to a collective fund. Each member of the group can expect all or some of this collective fund to rotate around in his favour. For a detailed publication on the various informal systems see "The poor and their money, an essay about financial services for poor people", Stuart Rutherford, University of Manchester, 1999. Also available via *www.devinit.org/findev/papers.htm*

The main method of achieving this in cooperative structures is social control between the members of the organisation.

The more formal banking structures rely on real (mortgage) collateral to cover themselves against bad loan repayments. As a result of the criteria this involves, credit is usually only available to those who already have money. According to these standards, most of the world's population is not creditworthy.

## WHO IS SERVICED BY THE MICROFINANCE SECTOR?

In general, the microfinance sector provides financial services for people who do not have access to commercial banks because of their socio-economic profile. These are poor people, with no fixed income, who are unable to offer material collateral.

However, the threshold is not purely financial - it is physical and social too. In developing countries, commercial banks are practically non-existent in rural areas. The distances between these areas and the cities are enormous, and travel is expensive. Even when banks are close to the lower-income populations of a city, the gap in living environments and cultures is usually much too great.

In this context we should not view a poor person too narrowly as a person without money. Having no access to financial services is just one aspect. In practice, access to insurance systems, healthcare and education is also limited. This is why

microfinance institutions (MFIs) develop broader (social) activities. However, expectations may not be set too high. MFIs will never offer a total solution to problems of a social nature. They work on the basis of financing, and financing is merely a means of contributing to greater equality.

This vision of the role open to financing organisations is not a recent one. It was voiced more than a century ago by people like Schultze-Delitzsch, Desjardins and F.W. Raiffeisen. The latter founded the cooperative rural savings and credit system in Western Europe and was seen as a social reformer at the same time.

## A FEW CHARACTERISTICS OF MICROFINANCE

One well-known MFI is the Grameenbank in Bangladesh. This "bank of the poor" was set up in the 1970s by M. Yunus who was convinced that fighting world poverty is a question of (political) will rather than financial resources. Like F.W. Raiffeisen, he took the position that charity is no solution, for it affords poor people little in the way of initiatives to improve their situation. History has shown that self-awareness and a sense of self worth on the part of the borrower are just as important to an MFI's success as good financial management.

Since microfinance institutions deal with customers who constitute too much of a risk for the commercial banking circuit, it is only logical that they should put other mechanisms in place to develop a stable organisation with affordable services for its customers. Two characteristics common to nearly all MFIs are the proximity principle and social control.
Most organisations operate in a decentralised manner. Not only are they close to the customer in the geographical sense - they are close in the social sense too. The MFI's workers are familiar with the local communities, and often come from the community itself. Obviously, when selecting these workers, it is essential that they enjoy the trust of that community. This proximity is also essential if the organisation's finances are to be adequately managed.
Since little use is made of formal guarantees, it is important to exercise social control in the matter of repayments and in the organisation's financial management. This solidarity, or, to put it more appropriately, social pressure, is even stronger when group credit is involved. Responsibility for repayment then rests with the group. In many MFIs, group members cannot receive credit until the last loan has been paid off.

MFIs also invest in training, not only for their own personnel, but also and more particularly for their customers. These training programmes usually cover the activity for which the loan was requested. They involve modules such as book-keeping, technical training, sales techniques, and so on.

When working with groups, there are courses on group techniques, conflict resolution, administrative management, rights and duties of group members, articles of association, etc. Some institutions go even further and offer literacy programmes. These skills increase the repayment rates under the lending programmes. However, they also represent an expense that cannot be fully accounted for in the cost of the loans, and for which the MFIs rely on external subsidies. In recent years the clear trend has been to achieve a structural separation between financial and non-financial activities. This has happened not only under the impulse of donors, who have sought clarity over the financial viability of the organisations they support, but also under the impulse of legislators in the different countries.



There was little recognition of the microfinance industry until 15 years ago, and the authorities sought solutions through normal banking circuits. Microfinance activities were classed as "informal financing" or "non-institutional financing" - a parallel financial circuit subject to little in the way of official regulation or control. In the meantime, we have come to realise that these structures could in fact channel financial resources to the more vulnerable groups (e.g. *Pronaf* loans in Brazil[2]). At the same time, there has been a recognition that better regulation and supervision is needed to protect the small saver and borrower. Another motivating factor is the potential for governments to generate income. This is why specific legislation has been implemented in many countries (Tanzania, Ecuador, Guatemala, Cameroon, etc.). The sector itself realises that a shift towards the formal banking circuit is a necessary step towards institutional sustainability. One such move would be to introduce more transparency from the outside. In this context we can equally state that much has been done in recent years to evaluate the sector more uniformly, thereby facilitating mutual comparisons[3].

## LOANS: THE MOST COMMONLY KNOWN FINANCIAL PRODUCT IN MICROFINANCE

The most commonly known financial product is the loan. Loans are usually given for productive trade, crafts and agricultural activities. Short-term in the main, they vary from a few months to one or two years.

Some organisations provide loans for housing over five to ten years, but these are fairly unusual. Most MFIs focus on trade and crafts. Agriculture is particularly risky because of climatic conditions, limited product life and fluctua-

[2] Under a special credit line known as Pronaf, the Brazilian government channels subsidised agricultural loans for farming families via micro-lenders such as Cresol (cooperativas de crédito rural com interaçao solidario) in the state of Parana.

[3] "European Initiative for Performance Evaluation of African MFIs" was coordinated by the NGO ADA (Luxembourg). More information available from *www.adaceremlux.lu/programme_pilote.htm*. An interesting document in this context is the note published by CGAP on financial transparency in MFIs: *www.cgap.org/html/p_focus_note22.html*

ting market prices. Agricultural loans have to be tailored to seasonal income and expenditure cycles, whereas most MFIs operate with weekly and monthly repayment schemes. It is clear that the sector will also have to develop custom products, and that the MFIs will have to specialise according to the target groups with which they work.

The rates of interest applied by MFIs are higher than those in the formal banking sector but lower than those of the "loan sharks".
There is little point in comparing MFI rates against those of the formal banking sector because the poorer target groups barely have access to these formal loans in any case. As we are dealing with smaller sums and more intensive monitoring, it is only logical that the costs and interest rates would be higher than those applied by the commercial bank. As a rule MFIs generate very small profits, and simply covering the operating costs[4] is already viewed as a positive outcome. However, profits are needed if sustainability in the long term is to be guaranteed. The challenge facing the MFI is to maintain profitability without losing sight of the original, poorer target group and therefore without concentrating on larger, less risky loans.

However, it does make sense to draw a comparison with the rates of the "loan sharks". Usually, these are private individuals who offer loans without a great deal of formality, but whose interests rates can be up to ten times higher than normal banking rates. They may also frequently be described as unscrupulous. However, it is worth noting that these private moneylenders continue to operate even when a local MFI is offering an affordable alternative.
They do so because their procedures are shorter and cheaper. For example, they set fewer extra demands in terms of checks, training and waiting time. In addition to these objective factors there is the element of "certainty". Many MFIs have failed due to an overly social stance, bad

[4] Operational and financial expenses

management or a restricted size, and so confidence in them has suffered a setback. It is to be expected that borrowers will spread their bets and move away from the private moneylenders only gradually.

In addition, the demand for loans is far greater than the MFIs can supply at present. In the run up to the world microcredit summit in 2002, it is estimated that current supply meets only about 5% of demand.

## MICROFINANCE INSTITUTIONS ENCOURAGE SAVINGS

Alongside credit facilities, the provision of savings facilities is at least every bit as important. Even the poor can and wish to save; they lack only the possibility, not the capacity. For people with little in the way of money and only limited access to insurance and external financial resources, it is even more important that their savings be properly managed. People can save in different ways, and not necessarily in money. People on low incomes usually resort to alternative methods of saving because the normal financial structures will not accept their savings. They can save in land, livestock or jewellery, or deposit their cash savings with another for safekeeping.

The cooperative organisations place a heavy emphasis on saving and it is not infrequently the case that savings are required for access to loans. These cash savings perform several functions. To the saver they offer a buffer against unforeseen

outlays, as well as access to loans. Safety is another reason for saving with a financial institution - not just to prevent loss or theft, but to prevent oneself and other members of the family from squandering the money on lower priority items. For the financial institution, these cash savings form a substantial and often cheap source of financial resources. In this case the concepts of confidence, control and good management are even more important, since this is the hard-earned cash of a vulnerable group that will be extremely hard hit if the organisation fails. The organisation needs even greater banking expertise and must take pains to ensure the solvability and liquidity of the MFI. If it is set up as a non-governmental organisation (NGO) the MFI will be unable - from the legal point of view - to mobilise and convert savings to loans. However, it does have the power to block savings temporarily as a means of guaranteeing the credit given. This actually freezes the financial resources, which are all too scarce, and should be avoided in a sector where surplus savings already enter circulation only sporadically. Development programmes give MFIs cheap financial resources in the form of donations or cheap loans. Despite this, however, credit volume is usually limited compared with the demand for loans.

## OTHER IMPORTANT SERVICES IN THE MICROFINANCE SECTOR, SUCH AS INSURANCE

Traditional savings and credit systems usually function as insurance mechanisms too. In so-called *tontines* - where the members take it in turn to use the money collected - the group will contribute extra if one of the members is faced with an unforeseen expense, such as illness or a death in the family. This social function also remains a feature of MFIs. Although they mainly provide loans for productive income-generating activities, their customers' needs are more varied than this. Financing is also needed for education and healthcare, and unforeseen social activities. MFIs must turn their attention to these financing requirements too. It makes no sense to ignore them, because the customer will fund these expenses with his productive credit, or turn to the private lender and in this way enter a vicious circle of debt.

Customer training programmes on the issue of loans and savings remain necessary not just for the sound operation of the organisation itself, but also as a means of strengthening the customers' capacities.

Saving programmes (even compulsory savings), which provide a buffer against unforeseen circumstances or non-productive investments, are an important service offered by any financing organisation.

In the last five years we note a clear tendency to develop specific insurance products that tie in with the capacities of MFIs. For example, these insurance policies may take on the debts left behind when someone dies (balance of debt insurance) or compensate the relatives for a loss of income, by paying school fees for children. In healthcare too, efforts have been made to tie in the workings of the mutual health funds with the vision of the cooperative MFIs.

The need for "microinsurance" is great, but experience in the field is limited. Since insurance is based on the law of numbers, so as to spread the risk, these organisations should have a reach that is as wide as possible, either through their own growth or by working with other organisations.

## CONCLUSION

Microfinance is by no means "banking on a small scale", and it is more than a bundle of financial transactions. MFIs offer financial services which commercial banks are unable to provide, by working with customers who are not creditworthy (read profitable) according to the standards imposed by the established structures. To make management affordable they use control mechanisms, such as social control via group loans. Their place must be as an alternative to private lenders, who sometimes charge extremely high rates but at the same time operate quickly and with the minimum of formalities.

Organisations in the microfinance industry play a social role. Saving and credit systems represent a way of giving large groups of low-income earners a chance to live a better quality of life. This requires more than money.

Capacity building and guidance are every bit as important. These costs cannot simply be passed

on to the borrowers alone. A certain level of subsidy is needed. In recent years the tendency has been not to keep everything in the same structure, but to put banking activities aside in a specialist organisation. It is generally accepted now that this service provision, i.e. pure microfinance, can be developed in an economically viable manner. It is important for these organisations to operate within a framework of external control - not only does this increase the confidence of the customers, but it improves the transparency towards the organisations that support them. It is not desirable for all the services made available to the poorer target groups to be housed under one and the same roof. After all, it is not possible to be a jack of all trades. There is clearly more recognition and interest from the commercial banking sector in the financial area. However, there is still a wide gulf, along with distrust on both sides. So the aim must be to promote a mutual exchange, in order to meet the demand for microcredit. Guarantee funds can be an appropriate instrument in this context. ■

2

# WHAT IS A GUARANTEE FUND?

## WHAT IS A GUARANTEE FUND AND WHY IS IT NEEDED IN THE MICROFINANCE SECTOR?

A guarantee is a financial instrument used to protect a credit institution (usually a commercial bank) against a borrower who fails to repay his loan. The guarantee is an irrevocable promise by the guarantor to the lender: if the borrower does not repay the loan, the guarantor will meet the borrower's obligations in full or in part. In this way the guarantee fund covers the losses incurred by the credit institution that have resulted from lending. When designing an instrument of this type, it is crucial that the risk be spread between the three parties involved: the guarantee fund, the credit institution and the guarantee holder. This prevents a lack of discipline creeping into the repayments.

It is known that smaller companies, even though they may have good economic prospects, find it difficult to obtain bank credit. In most developing countries the traditional financial structures (mostly banks) tend to refuse to grant loans to microenterprises. The banks view the risk as too high. Potential borrowers are unable to demonstrate their creditworthiness by means of proper accounts or a previous credit history, and are unable to offer the bank sufficient collateral. A microfinance industry has been created alongside the formal financial structures, aiming precisely at microenterprises, which are usually informal in nature. The MFIs have usually built up their portfolios through donor funds. However, these donations are limited in size. In recent years the microfinance sector has mushroomed, and it is on the lookout for extra sources of financing. However, the capital market views MFI fund applications with the same distrust as the commercial banks show for microenterprises.

It is within this context that the mechanism of the guarantee fund is gaining ground. The guarantee fund makes the risk of granting credit to "unknown" borrowers acceptable to the lenders. Thus the guarantee mechanism offers valuable potential for linking the existing financial channels to a new group of customers.

MFIs and other organisations are viewed as high-risk because many aspects of their business are unknown to the banks. This is known as *asymmetry* of information, and it always carries the risk of abuse of confidence. After all, the borro-

wer is much more aware of his own *creditworthiness* than the lender. Therefore the trust of the lender is open to abuse if a borrower presents his creditworthiness as being better than it actually is. This phenomenon is known as *free riding*. The use of a guarantee fund can be a stimulus for commercial banks to lend directly to microenterprises, or to provide a credit facility for an MFI. Operating "on-the-job", the guarantee fund aims to obviate the need for itself on the long term. It is counting on the fact that bringing the various parties together can create a better understanding, through which the bank can trust in its new customers in the future, even without the guarantee fund.

## EXPERIENCE OF GUARANTEE FUNDS

The guarantee fund clearly meets a need. And yet this mechanism is not without controversy and its fair share of adversaries. Until the mid 1990s, the view prevailed that guarantee funds were of no use and were actually inefficient. On closer inspection it was seen that this conviction rested on negative experiences with guarantee funds utilised to back subsidised agricultural loans in developing countries. These public guarantee funds were widespread in the 1970s and 1980s. They had a centralised structure, which led to bureaucracy and inadequate management. Moreover, these guarantee funds were dependent on the state budget. Political influences weighed heavily. By the end of the 1980s,

## The decline of the public guarantee system in developing countries: an illustration

*An example from India illustrates the loss of the public guarantee system in developing countries. In the 1980s, two guarantee funds were created under the umbrella organisation of the Deposit Insurance and Credit Guarantee Association (DICGA): one for small-scale industrial enterprises, and a second for other, small-scale lending. In addition, special lines of finance were provided for the banking sector, to offer loans in these segments.*

*Participation in these systems was compulsory for all large Indian banks. For loans under 25,000 rupees (about 580 euros) the system was free of charge and covered 90% of the credit sum. For loans exceeding this amount, a fee of 0.5% was charged, with identical cover of 90%. At a later stage this percentage was reduced to 60%.*

*The banks made massive use of the finance for directed credit, and of the guarantee funds linked with them. A guarantee was automatically linked to every approved loan. And guarantees were called in automatically: as a soon as a bank wrote off a loan, and all attempts at collection appeared fruitless, the claim was automatically processed. The system operated so smoothly that when granting a loan most banks would fill in the claim forms in advance, so that they would be ready to send off at the appropriate juncture.*

*In 1995 the claims backlog at DICGA had run up to 4.2 million. Finally, in 1999, the entire banking sector withdrew from the system and DICGA was forced to wind up.*

most of the schemes had been bled dry through corruption and *free riding*.

In the early nineties we saw the second "generation" of guarantee systems. In recent decades the chronic shortage of credit financing for smaller companies has occupied a more prominent place in development policy (in the North and South). There was a need for mechanisms that create new points of access to the institutional credit market. The guarantee mechanism appeared to be a useful tool in furthering these relations, and new models were developed.

These new models attach a great deal of importance to matching the prevailing market prices, repayment discipline, and spreading the risks between the parties. They are designed to bring more trust into the relationship between the credit institution and the borrower. The greater the

trust, the fewer the risks to be covered by the guarantee fund.

But even with this new generation a number of old problems have resurfaced. The most notable is probably that of *moral hazard*, which occurs when a bank tries to offload its riskiest loans on the guarantee fund, and is lax in monitoring the repayments. Other problems include stiff procedures for securing a guarantee (with loss of time), and limited refinancing possibilities for guarantee funds that have met with repayment problems.

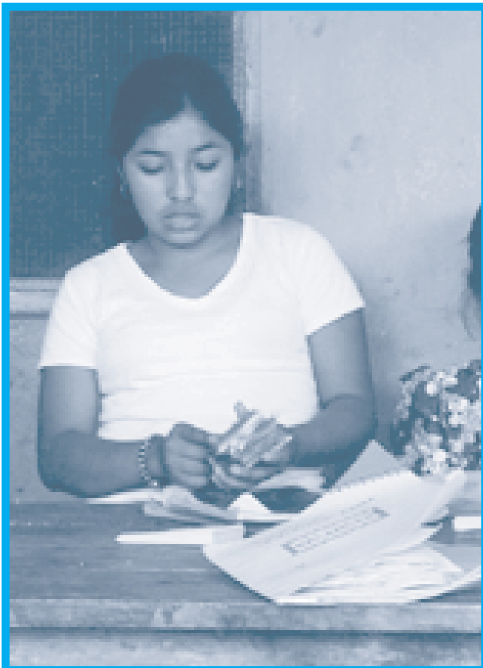
## A FEW MODELS OF THE GUARANTEE FUND

Several models of guarantee fund stimulate the formal financial sector to lend money to microenterprises. Of the second generation of guarantee funds described above there are three models worth mentioning. These models involve the following parties:

Guarantor
Credit institution
Guarantee holder
Borrower

The agreements reached between these parties determine the type of model.

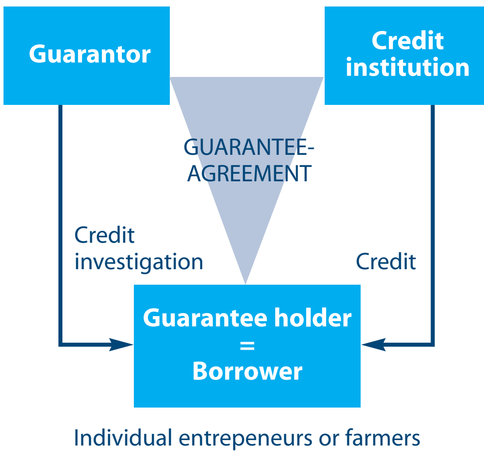




### The individual guarantee model

In the individual model we note a direct agreement between the guarantee holder, the guarantor and the bank. The guarantor - the guarantee fund - screens individual entrepreneurs (or farmers) seeking to approach a credit institution (bank) for credit with the help of a guarantee. The guarantee fund and the bank work under a co-operation agreement in which they split, on a percentage basis, the risk associated with a given credit application. By way of guarantee the guarantee fund gives the bank *a letter of credit* covering its percentage. The bank assesses the credit application, according to its own criteria this time.

It can now take account of the reduced risk afforded by the guarantee. If it approves the loan, an individual contract is drawn up between the borrower and the bank. The diagram below summarises the relations involved.

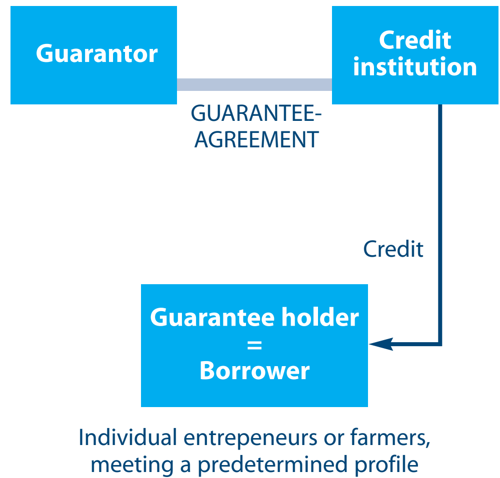



The guarantee holder pays the guarantee fund a commission, which is calculated as a percentage of the amount given in the guarantee. The bank can collect and pass on these commissions. If the borrower defaults, the guarantee fund is bound, on the basis of the *letter of credit*, to repay the bank its guaranteed share of the credit.

### The portfolio guarantee

Under this model, the guarantee fund no longer screens the individual guarantee holders. The guarantee fund arranges with the bank to guarantee a certain group of potential borrowers. In real terms they set out a number of criteria for customers and/or credits. The undertaking to provide a guarantee for these credit requests is fixed in advance.

The criteria relate to the borrowers' characteristics, credit ceilings, the purpose of the loan, the selection and assessment of credit applications, arrangements over the guaranteed percentage of the credit sum, the procedures for settling guarantees and handling disputes. Through this the guarantee fund can be certain that the exact target group it specifies, e.g. informal entrepreneurs, is making use of this credit line. The diagram below summarises the relations involved.



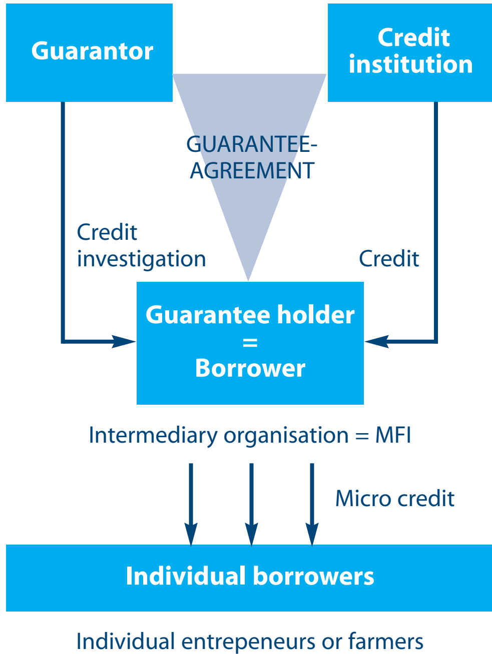



In this model the guarantee fund is much less involved with the guarantee holders. All loans meeting the criteria are automatically covered by the agreed percentage. Sometimes a borrower is hardly aware that he is also the guarantee holder. The costs are calculated into the loan repayment scheme and the bank passes them on to the guarantor.

## The intermediary guarantee model

In the third model, use is made of intermediary organisations, which are better placed than the financial institutions to provide microenterprises with credit at an affordable price. These intermediary organisations are generally MFIs.

In this scheme the guarantee fund guarantees the bank the credit line that an MFI uses. These funds enable the MFI to extend the volume of its credit portfolio for microenterprises. The MFI has its own methodology for granting microcredit and is in a position to carry out these transactions cost-efficiently. The MFI is responsible for recovering the microcredit it grants. The diagram below summarises the relations involved.



The guarantee offered by the guarantee fund assures the bank that the credit will be repaid if the MFI is in default.

Systems other than the guarantee mechanisms described above can help smaller businesses gain access to credit. A prominent example is the *mutual guarantee association* (MGA). The main characteristic of the MGA is that the guarantee holders are all members of an association. The members contribute to a fund that offers guarantees. The mutual aspect is a reference to the common link between the members of an association. This association is usually a professional association.

All members are liable for loans guaranteed by the MGA. In some countries this mechanism is widespread. In Italy, for example, there are about 700 MGAs, known as *Confidi*, spread over just about every sector of the economy. When assessing a guarantee application these MGAs do not confine themselves to the financial dimensions, but look at the personality of the applicant, technical qualifications (which a professional organisation is well placed to do), and the location.

In the EU, the European Commission has been supporting MGAs since 1991. Experience in this area has been studied by the International Labour Organisation and the findings disseminated beyond the borders of the Union. At present MGAs are still in their infancy in developing countries.

The individual guarantee and credit portfolio guarantee models have no effect on one of the main obstacles behind the shortage of loans for microenterprises. It is indeed true that they provide a solution to the shortage of guarantees that can be offered by the smaller businesses themselves. However, there is an equally important problem: transaction costs that are high for volumes that are small. For example, where administration costs are concerned, there is little difference between a loan of 1,000 euros and a loan of 100,000 euros. When, as a result of offering all this microcredit, a credit institution is forced to take on extra staff and managers, this has a direct effect on profitability. These two models have had only a limited effect, therefore, in opening the doors to credit for microenterprises.



A major advantage with the intermediary model is that the bank itself does not have to develop new credit products to tackle a little known market. The MFI is already familiar with the market and with this type of service. Moreover, its internal organisation has taken shape through the cost structure specific to microcredit. This makes it well suited to covering the costs of granting microcredit. Obviously, this type of credit involves higher costs than ordinary bank loans.

Some international networks of MFIs (such as ACCION, Women's World Banking, Finca) have their own guarantee fund. They bring together MFIs from all continents, but the majority comes from Latin America. As and when affiliated MFIs grow into formal financial institutions, they find more direct connections with the local capital markets.

This presents the challenge of searching for new applications for guarantees, and of designing sophisticated financial instruments that meet the altered needs of the network. In Bolivia the well-known MFI, BancoSol, a member of the ACCION network, used guarantees to issue its own bonds and offer these on the local capital market. In this way BancoSol was able to attract funds from local investors and use these for the purpose of lending.

## THE GUARANTEE MECHANISM

Within the models described, a variety of guarantee mechanisms can be selected.

### The subsidiary guarantee

A subsidiary guarantee relates only to a portion of the credit, i.e. that part which cannot be guaranteed by the guarantee holder's own securities. It can only be called upon after the guarantee holder's own securities have been used. In this set-up the bank and the guarantee fund always share the risk, which stimulates the bank to monitor the loans.

### The extra subsidiary guarantee

This is a mechanism which, like the latter, requires the guarantee holder to provide a part of the guarantee, but where the loan is repaid through several capital repayments. The guarantee runs only until the extra part of the bond is strictly required, or, in other words, until the repayments have brought the outstanding loan below the level of the borrower's own securities.

### The joint and several guarantee

The guarantee fund can also take joint and several responsibility vis-à-vis the bank for the repayments. Should the loan fall into arrears, the bank will be entitled to claim repayment in full from the guarantee fund.

This system is less suited to direct guarantees on very small loans. However its application is fairly widespread for institutional guarantees of the type in the intermediary model.

## WHAT ARE THE ADVANTAGES AND DISADVANTAGES OF GUARANTEE MECHANISMS?

A guarantee fund offers a number of clear advantages and disadvantages.

The main **advantages** are the following:

- It builds a structural link between small lenders and the formal financial sector.
- It increases the quantity of credit financing available for microenterprises.
- The fund creates *additionality*, or, in other words, it stimulates banks to offer credit to a sector that would not normally have access to formal bank loans without this mechanism.
- It initiates a learning process by which the banking sector learns to make a more accurate assessment of the risks associated with granting credit to microenterprises.
- The mechanism can act as a lever for converting scarce donations into broader microcredit funds.
- The exchange rate risk can be taken from the equation for the guarantee holder and guarantor alike. The mechanism allows us to stimulate lending from a strong currency environment to a country with a weaker currency.



In the long term there may be other advantages for the actual process of granting credit, such as better loan conditions, longer periods, lower guarantee requirements and possibly lower rates of interest.

However, the critics of the guarantee fund point to the following **disadvantages**:

- The very high cost of collecting information on the guarantee holders, analysing this information and following it up. This means that most guarantee funds find it very difficult to cover their costs.
- The issue of a guarantee makes the bank a little less inclined to monitor its loans with care. It can lead to a certain degree of laxity, which opens the door to abuse.

- In addition to the normal credit risks guarantee funds are also open to abuses such as *free riding* and *moral hazard*. This can mean that the repayment rate on guaranteed loans can be lower than originally foreseen.
- Covering losses can considerably erode the size of a guarantee fund.
- The mechanism does not operate well under some macro-economic conditions. When the local financial sector is lacking in liquidity, a guarantee fund cannot stimulate banks to grant credit.
- The costs are rarely charged on the basis of the risk that each party runs, and so the weaker parties to the agreement are forced to carry disproportionately high costs.
- There are doubts over the *additionality* argument.

It has also been pointed out that a guarantee does not always ensure access to credit. Other elements, such as an influential director who can open a few doors, are often needed to ensure that an agreement is reached.

## A FEW KEY ELEMENTS IN THE DESIGN OF A SUCCESSFUL GUARANTEE FUND

### Clear objectives

In the first place we aim for a certain degree of *additionality* by placing a group, which has been excluded until now, within reach of credit. To this end the guarantee mechanism should reduce the obstacles that prevent access to the financial channels. It may be easier and more efficient to work with selection criteria rather than individual applications. On top of that, the guarantee fund aims to establish a learning process, so that in the long run guarantee holders can win the trust of the credit institution without this external guarantee.

### A leverage effect

Every guarantee fund should aim to work cost effectively. Creating a financial lever is an essential step along the way. After several years of activity, a guarantee fund should be in a position to guarantee a volume of credit that exceeds its own several times over. Failing to create this lever can lead to doubts over the repayments to be expected. If the banks do not share in the risk,

this may even call the fund's purpose into question. The lever determines the spread of the risk as well as the cost price.

## Credibility

The guarantee fund must have sufficient financial assets to meet its obligations without problem. Claims on a guarantee should not be held up by excessive red tape. Moreover, the fund should select its guarantee holders in a transparent and objective manner.

## Transaction costs

What stops banks from lending money to smaller companies on a larger scale is the high cost of transactions, which has a direct effect on profitability. Saving on the cost of lending is therefore a critical aspect. To a large extent, the current preference for the intermediary model rests on this element.

## Curtailment of the risk of abuse

The guarantee fund must employ means of curtailing the risk of abuse. One important element is the duration of the guarantee, particularly when a letter of credit is used, (after all, the guarantor cannot give notice on a letter of credit unilaterally at any moment). Guarantees are temporary in nature.

The following conditions also contribute to the success of a guarantee fund:

- A credit market in which the banks do not meet the demand from microenterprises
- The guarantee holders must be prepared to pay, and be capable of paying, the normal commercial rate of interest[5] to the credit institution
- A legal framework for guarantee funds (including the regulating authorities' risk assessments of guarantees offered to banks)
- The fiscal framework
- The amount of liquidity in the financial system
- The reinsurance possibilities for the guarantee fund

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[5] plus the cost of the guarantee if it is passed on

- The profitability of credit granting in general, with regard to smaller businesses in particular
- The supply via other mechanisms, such as leasing
- The guarantee fund's own investment policy, including its view of diversification

## CHALLENGES FOR THE FUTURE

The use of a guarantee must be advantageous to all parties involved, and so it should not affect the responsibilities of those parties. This element is a key piece if it is sustainability that we are seeking. The challenge is to find the distribution keys for costs and benefits.

The intermediary model appears more fruitful than the other two because it seems to provide more additionality. It also addresses the problem of transaction costs in a more active way. To what extent can this yield a financial advantage for the borrower? Several questions remain unanswered when it comes to distributing the costs and risks. It seems hard at times to find a way around the lender and guarantor doing double the work. How do we reduce this to a minimum? The leverage effect and the use of a guarantee to help cover insufficient collateral are factors with a direct influence on the total cost relations. Spreading the costs and risks opportunely between the parties is without doubt one of the most important challenges before us. How much force can the lever take?

This need for an external guarantee is the result of an imperfect market. The guarantee fund bridges the information deficit. There is a current trend in the microfinance sector to standardise the financial information to be reported (from donors, central bank, etc.). This standardisation is gaining momentum, fuelled by the need for external financing. Although it lessens the cost of operation of a guarantee fund, it may render the mechanism useless in the future. ■

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3

# THE BRS SEMINAR ON GUARANTEE FUNDS

## CONTEXT

The Belgian Raiffeisen Foundation (BRS) supports savings and credit organisations based on cooperative principles. On 11 December 2001, BRS organised a seminar in Brussels on the use of guarantee funds in the context of microfinance. Guarantee funds are also in the ascension in fair trade (see the box on the Belgian government initiative). In preparing for the event it was decided to confine the debate to the model of intermediary guarantees. The BRS is concerned with the problem of the MFIs in the South, and their process of institutional development. One of the main obstacles here is the attraction of resources to develop the credit portfolios lent out to microentrepreneurs.

As shown in the previous chapter, guarantee funds can offer a solution to these financing needs. The intermediary model rests on the relations that the MFI develops with the formal banking sector. Through this, credit funds can flow from the banking sector to the MFIs, for the purpose of granting credit to microenterprises and farmers.

A number of organisations[6] with experience in this matter were approached to take part in the discussion, namely:

- ADA, Appui au Développement Autonome, an NGO from Luxembourg, which offers training and financing for MFIs;

- ILO, the International Labour Organisation, which has conducted extensive research into the success factors involved in the guarantee mechanism;
- Rabobank Foundation, which provides subsidies and soft financing for cooperatives in the South;
- SOS Faim, an NGO from Luxembourg and Belgium, which set up a guarantee fund for rural organisations in South America in 1992;
- IGF, International Guarantee Fund, a cooperative company which specialises in the provision of guarantees;
- Maquita Cushunchic, an MFI from Ecuador with a cooperative structure.



[6] Contact details for these organisation can be found at the end of this publication.

The seminar attracted 90 interested parties from all perspectives: the federal and regional governments, multilateral organisations, NGOs from the three Benelux countries, academics, MFIs from

the South, European guarantee and credit funds for developing countries, and financial institutions and their associations from Belgium and the Netherlands.



Confining the discussion to the intermediary model of the guarantee fund, and the triangular relationship that this implies between the guarantor, guarantee holder, and local credit institution (bank), gave rise to the first question in the debate. Is the creation of a relationship between an MFI and local bank really a necessary step in the institutional development of an MFI? The Rabobank Foundation is of the opinion that developing an MFI into a credit institution is only a secondary objective, and prefers to turn its attention to the aspect of organised trust. It would be better if the financing in local microfinance initiatives were achieved by mobilising the savings of the customers (or members). Developing relations with the local banking sector could be a step in the starting phase, but in the long term the MFI's relationship with the savers is more important. From this perspective the Rabobank Foundation concludes that in the starting phase external resources could just as well be channelled directly to the MFIs, and that a relationship with the local bank would bring with it little extra value.

However, the seminar focused on aspects of the intermediary model, which brings an intermediary organisation in touch with the formal banking sector. The box on the IGF gives a brief description of how this intermediary model can be applied in practice. The debate tended to centre on the stumbling blocks in the system, such as management of the costs and risks. The debate touched on 4 discussion points, which we will recount later.

## Belgian government takes initiative to set up a Fair Trade Guarantee Fund

*At the BRS seminar Eddy Boutmans, State Secretary for Development Cooperation, announced that the Belgian government is intending to set up a Fair Trade Guarantee Fund. Alongside microfinance, fair trade is another area in which guarantee funds stand to make an interesting contribution.*

*Economic growth in developing countries must take place with the active participation of the poor, so that they can contribute directly to the growth and take their share of the benefits. This means that economic growth should go hand in hand with the creation of sustainable employment, with health and education facilities, with the promotion of social organisations, with acceptable wages and concern for vulnerable groups. A well-functioning government is important in a growth model of this kind. And it is equally necessary that the private sector be given ample space to develop. Therefore an equal balance between the public and private sectors would be ideal.*

*With the creation of the Fair Trade Guarantee Fund, the Belgian government is taking an innovative and development-relevant initiative in the context of public/private development cooperation. The BTC (Belgian Technical Cooperation) will be given the task of managing the Guarantee Fund.*

*A few of the concepts behind the creation of this Guarantee Fund:*

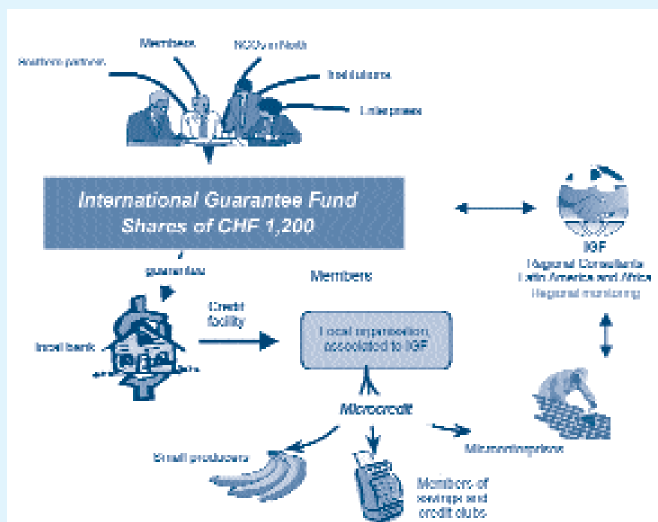
1. *The European consumer wants fair trade products;*
2. *The gulf between rich and poor continues to grow;*
3. *A major part of the working population in developing countries still does not have access to fair credit;*
4. *The EU-ACP Cotonou agreement has elements recognising that fair trade measures are necessary, and encouraging this type of initiative;*
5. *Besides conventional trade the European Commission recognises the existence and sense of the Fair Trade Initiative (FTI);*
6. *In its Federal Plan for Sustainable Development the Belgian government states that it will encourage an approval labelling system that promotes fairer trade.*

*It is the opinion of the State Secretary that with this initiative, Belgium is playing a leading role in considering the active contribution that can be made by the weaker manufacturing groups in a global economy.*

## International Guarantee Funds (IGF)

*The IGF is an international non-profit-making cooperative society, which was formed in Geneva in 1996. The IGF furthers the activities of the Swiss RAFAD foundation, which started working with guarantee funds in the mid-1980s. It is made up of organisations from the North and South whose collective objective is to fight poverty, organisations such as savings banks, coffee cooperatives and a small number of Swiss NGOs.*

*By guaranteeing loans, the IGF aims to create a relationship with local financial structures which enables it to operate in the local currency. As a cooperative structure it only gives guarantees for organisations that join and acquire shares in the IGF (at least 10% of the guarantee sum). The distribution is based on decentralised operation from three offices, i.e. Geneva, Cotonou and Guatemala, plus about ten local representatives in as many countries.*




### A few figures (in euros)

| **Distribution per region (year 2000)** | Guarantee (sum) | % | Leverage | Credit facility (amount) |
|---|---|---|---|---|
| West Africa | 116.848 | 10% | 1,1 | 128.532 |
| East Africa | 271.754 | 24% | 1,6 | 438.045 |
| Central America | 45.404 | 4% | 2,0 | 90.807 |
| South America | 691.797 | 62% | 4,3 | 2.991.562 |
| Total | 1.125.802 | 100% | 3,2 | 3.648.947 |

| **Distribution per sector** | Guarantee (sum) | % |
|---|---|---|
| Trade | 485.084 | 43% |
| Savings and credit | 143.548 | 13% |
| Microenterprises | 497.169 | 44% |
| Total | 1.125.802 | 100% |

*Source: IGF*

## The situation of the guarantee holder: the Maquita Cushunchic cooperative of Ecuador as a typical example of an MFI

The institutional development of the Maquita Cushunchic cooperative in Quito, the capital of Ecuador, illustrates the process during which the incorporation of a guarantee fund becomes appropriate. At the seminar, the president of the cooperative, Mrs Patricia Camacho, described the development as follows:

**Why was this organisation set up?**

- To give the population in the south of Quito access to financial services, particularly female entrepreneurs operating small businesses;
- To offer an alternative to the banking sector, which finds the costs and risks of granting credit to microenterprises too high;
- To reach people with a low income, and of whom the banks show little understanding, as a result of which they do not turn to a bank.

### State of affairs

| Amounts in euro | 1998 | 1999 | 2000 | Oct. 2001 |
|---|---|---|---|---|
| Number of members | 1,509 | 3,214 | 6,185 | 7,955 |
| Number of female members | 925 | 1,925 | 3,714 | 4,535 |
| Number of male members | 584 | 1,289 | 2,471 | 3,420 |
| Assets | 113,175 | 161,358 | 575,647 | 947,826 |
| Liabilities | 87,208 | 127,291 | 479,868 | 818,872 |
| Equity | 25,966 | 34,067 | 90,344 | 123,483 |
| Total savings | 65,480 | 113,520 | 386,234 | 573,545 |
| Average savings per member | 32 | 27 | 49 | 54 |
| Outstanding credit | 91,986 | 155,138 | 370,578 | 721,340 |
| Arrears (PAR 30[7]) | - | 0,73% | 0,48% | 0,39% |
| Number of loans granted per period | 402 | 798 | 804 | 1,401 |
| Savings / credit ratio | 71% | 73% | 104% | 80% |

The figures in the table clearly show the gradual growth of the cooperative. We also see that almost across the board, the members' savings remained behind the demand for loans. From the outset Maquita had to call on external sources to bring its credit granting up to level.

[7] The method of calculation is "Portfolio at risk" after thirty days. A percentage is calculated by dividing the total outstanding amount of the credits, in default for thirty days or more, by the total amount outstanding in the credit portfolio. The figure shows how much of the outstanding credit can be lost if the current trend in default continues.

According to Maquita, there is still an enormous unsatisfied demand for credit in the southern districts of Quito. Only a small number of institutions are prepared to react to this demand, but they do not have the resources to satisfy it.

As we can see from the defaults, the quality of the lending is extremely good. Nonetheless, Maquita can barely appeal to the local financial sector because it can offer no traditional guarantees and has difficulty demonstrating its creditworthiness. This touches a sore spot, because the lack of trust from the formal financial sector puts the cooperative's chances of obtaining affordable finance at risk. During the contacts to solve this problem they looked at the possibilities offered by a guarantee fund. The stumbling blocks they came across were put before the panel as points for discussion.

## DISCUSSION POINT 1: What can a guarantee fund do to strengthen the trust of the formal financial sector?

A guarantee is provided to strengthen the negotiating position of the organisation requesting credit from the bank. The financial instrument used to grant the guarantee, *the letter of credit*, is a well-known instrument in the world of banking. Thus the guarantee fund aims to raise the creditworthiness of the guarantee holder in the eyes of the bank.

The IGF deposits its funds and obtains its letters of credit from one of the larger Swiss banks. The reputation of this bank lends extra credibility to the guarantee mechanism. This provides leverage with the local bank so that, on the basis of the guarantee, it provides a loan far in excess of the guarantee sum. The experience of IGF/RAFAD is that on the medium term an average leverage of three can be achieved, or, in other words, the partner receives three times as much credit as the IGF gives by way of guarantee. This means that for every euro that the IGF has in its guarantee fund, the microenterprises can invest three in their businesses. However, it usually takes a few years before the local bank decides to carry part of the risk. Therefore, the leverage effect seldom plays a role from the very beginning. To encourage the banks to share the risk the IGF asks the guarantee holder to contribute a guarantee of its own, such as a mortgage on its buildings.

In 1992 SOS Faim set up a guarantee fund for associations of producers (such as coffee farmer cooperatives) and MFIs that offer their services to organised groups of this type. Between 1995 and 2000, guarantees totalling 6.2 million euros were issued. SOS Faim managed to achieve an average leverage of 1.65 on its guarantees in this period. This resulted in a total credit volume of 10.27 million euros for the intermediaries. They were able to provide almost 15,000 microcredits to their members.

The guarantee fund is responsible for correctly selecting these intermediary MFIs. In SOS Faim, this translates to a high-risk profile among the guarantee holders, because they mainly issue guarantees to partner organisations in their NGO operations. However, this deliberate choice leads the banks to restrict their acceptance of risks, which in turn weakens the leverage effect. However, as SOS Faim points out, a higher leverage does not necessarily mean that the local bank will actually decide to accept the risk. It is often the case that a higher credit volume can only be obtained if the borrowing intermediary provides extra guarantees, such as a mortgage. Though an external guarantee may be available, it can prove difficult to achieve any real leverage. The example of La Florida says it all. Therefore, in marginal cases, leverage is not merely an important aspect, but rather a way to access finance that otherwise would simply not be available.

ADA turned the seminar's attention to the ranking order in the distribution of the risk. ADA issues guarantees with a minimum leverage of two. Since this leverage remains in place for the entire life of the loan, the guarantee sum reduces in proportion to the amount of credit repaid. The guarantee is reviewed annually, based on the amount outstanding on the loan.

### The La Florida Producers' Cooperative of Peru

*In 2000 this cooperative attracted a loan to finance exports of coffee. It borrowed 672,332 euros from a local bank. For this loan SOS Faim and IGF/RAFAD provided La Florida with guarantees amounting to 295,826 euros. But in addition to these guarantees, the cooperative mortgaged its buildings. That mortgage had a value of 419,535 euros.*

*Counting everything together this gives a leverage of less than one. But this simple calculation is not enough to express the real leverage. The cooperative's managers were of the opinion that the bank only considered the loan because of the external (foreign) guarantors. The mortgage would have been of little value if the guarantee fund had not made a contribution.*

*To the producers of La Florida, the added value of the guarantee fund was greater than the difference between the guarantee sum and credit sum, but it was a matter of having or not having a credit facility to help them commercialise their most important crop.*

Therefore the borrowing bank covers at least 50% of the risk (to obtain the leverage of two). The general practice is that ADA covers 90% of the remainder and leaves 10% of the risk to the MFI. The MFI's share is covered by a term deposit endorsed to the lender. This guarantee carries the first risk. ADA's guarantee carries the second risk.

The ILO pointed out that leverage also plays a role in the European context. The Netherlands has operated the *Kredietregeling voor Midden- en Kleinbedrijf*[8] (Small to Medium Enterprise Credit Regulation) since 1915. All the large banks have signed up to this system, which provides more than half a billion euros in guarantees for about 3750 Dutch SMEs every year. The banks act as a distribution channel and are even free to decide themselves whether or not a state guarantee should be linked to a given loan application. This mechanism comes with a fixed commission of 3% as well as a leverage of two (the bank must give credit equivalent to twice the guarantee sum).



For ADA, the leverage of the guarantee is essential - not because it removes the risk, but because it distributes it. This is the first step in the process of learning how to manage risk, and can be extended to the management of liabilities under the criteria of stability and sustainability. In this perspective guarantees are a transitional instrument and therefore temporary in nature.

If we want to improve the relationship between the MFI and the local bank, the instrument must have a favourable effect on the local bank's cost of lending. The intermediary model is proven to limit the local banks' costs. There is no need to invest in staff or product development to service the microenterprise sector. The guarantee brings the risk and therefore the cost further down. Nonetheless, this cost-lowering element does not always counterbalance the risk aspect. In the African context in particular, the local banking sector is often very cautious of risks. Especially when it has only just come into being itself, as is often the case.

The crucial factor here is that the local bank perceives a reduction in the risk (e.g. guarantee via letter of credit from a reputable financial institu-

[8] In Belgium we have the Agricultural Investment Fund and Econex.

tion), and that the contractual provisions are very clear, with little room for interpretation or dispute. Furthermore, the reduced risk should not be negated by time-consuming procedures. Here, ADA refers to the "triggering", or the conditions that can lead to a payment of the guarantee. Prompt payment when a loan is (rightly) called in favours the system's credibility.

Obviously, pinning a relationship between the MFIs and the financial sector is no easy task, but this does not make it any less important. It is a learning process in which ample time should be taken, and in which we cannot expect high levels of confidence too soon. The distribution of the risks is the best indicator of progress.

## DISCUSSION POINT 2: What does it cost an MFI to use a guarantee fund and how can this be reduced?

Interest rates, even in hard currency (dollars), are relatively high in the countries of the South. In South America an interest rate of 18 to 20% in hard currency is about average. Although the guarantee is designed to increase the credibility of the guarantee holder in the eyes of the local banking sector, only in exceptional cases does it pave the way to better terms of credit.

The administrative and other management costs associated with the guarantee fund, and the losses too, make it necessary to charge the guarantee holder an extra fee for the service. Thus the IGF charges 4 to 5% per annum for a guarantee, and ADA charges 3.5% per annum. This may appear to be a very hefty additional cost, but it is an element that can be reduced through higher leverage (additional cost of guarantee = commission divided by leverage). The IGF raised the example of NYESIGISO in Mali (see frame), where a leverage of 3.3 was achieved. The additional cost for the guarantee on this loan is then 5%/3.3 = 1.5%.

ADA uses fixed guarantee commissions, which it does not differentiate in terms of the risk associated with the individual guarantee. ADA believes that this is the only way it can keep its guarantees affordable.

SOS Faim refers to the limited possibilities of achieving leverage in a certain context. The typology of the guarantee holder (rural character, unregulated etc.) constitutes a further restriction. SOS Faim offers its guarantee fund services free of charge to its guarantee holders. This clear positioning has enabled SOS Faim's guarantee fund to find a more or less unique niche, taking it away from direct competition with other funds.

ADA too recognises that extra expenses on top of the financial costs of the loan are a disadvantage for the guarantee. The majority of its guarantees go through special credit channels in the

North, and not local banks in the developing countries. By using alternative channels of credit it is possible to obtain better interest conditions, at rates of between 6 and 9%.

Different organisations in the North offer long term loans at better rates than can be obtained from commercial banks in the South. Not only are these alternative channels cheaper, but they are also prepared to analyse the application thoroughly and monitor it seriously. Here there is a real development of relations between the lender and the guarantee holder. This is why there has been a major shift in the use of the guarantee fund by SOS Faim. In 2000, organisations such as Alterfin, Oikocredit and Etimos received 31% of SOS Faim's guarantees, whereas this figure was only 11% in 1997.

## NYESIGISO in Mali

*In Mali, one of the poorest countries in the world, the informal sector accounts for 80% of the economy. Despite high levels of liquidity in the financial sector, the latter is not really prepared to grant credit to informal enterprises.*

*Nyesigiso, a local savings and credit organisation was created in 1987. In 1997, after steady growth, the organisation was confronted with such an increase in the demand for credit that it found it impossible to meet. A guarantee of around 88,000 euros was obtained from RAFAD, with which a credit facility of 3.3 times this amount was guaranteed at the local bank, the Banque Internationale de Mali.*

*With this, in 1997, Nyesigiso was able to offer credit to 5,828 microentrepreneurs, which gave an immediate boost to local employment. On top of this a number of other savings groups joined. More and more women were reached through group loans. A woman rose to the top of the organisation.*

*The broadening of activities had a very positive effect on the financial results. In 1999 Nyesigiso managed to repay the credit, as a result of which the guarantee was released. This happened eight months before the due date agreed with RAFAD. There was no need for further guarantees after this because Nyesigiso, thanks to its growth, had become an interesting partner for the Banque Internationale de Mali.*



In this regard, the IGF distinguished another bright spot in the shape of the cooperative federations in the South, which can also be an alternative to the commercial banking sector.

In certain cases, organisations like the Rabobank Foundation have gone a step further by offering direct credit at considerably lower rates of interest than those quoted above, in which the financial cost is subsidised directly (= soft financing).

On this point SOS Faim voiced the doubt that cost reductions are not passed on to the end

users of the microcredit. Though they do benefit from broader and quicker levels of service, direct cost reductions are not so immediately felt.

Guarantees inevitably involve costs. These may or may not be passed on to the guarantee holders. Nonetheless, we can say that the extra cost to an MFI for using a guarantee is determined first of all by the leverage vis-à-vis the sum borrowed. Negotiation of the leverage is crucial and it is recommended that plenty of time be spent on this. The objective should be to obtain a leverage of at least two. However, it is important for the MFI to maintain profitability at the end of the day.

## DISCUSSION POINT 3: CAN A GUARANTEE FUND BE FINANCIALLY SUSTAINABLE?

Every guarantee must be adapted to its context. And so we should look at each guarantee on a case-by-case basis, which implies costs. On the other hand, we can say that the instrument is flexible enough to satisfy a variety of contexts.

ADA has found that the guarantee fund is a contributing factor in meeting its social objectives as an NGO, but that it does not appear sustainable in economic terms. ADA views microfinance as a means of fighting poverty, which should be able to cover its costs, and this is relevant to the guarantee fund too. At the present time the sector is still at a very early point of the learning curve, not able yet to cover its costs in full. Nonetheless, ADA now believes that the progress made along the learning curve matches the financial results for its guarantee fund.

The ILO turned the seminar's attention to the rich European experience of guarantee funds. There are two dominant models in the European context: mutual guarantee associations (MGAs, common in Italy, Spain and France) and public guarantee systems (extensive in the United Kingdom, Belgium and the Netherlands).

MGAs have their origins in the tradition of the guilds and professional associations. Though MGAs have been brought to life in many different ways, what they all have in common is that they give their affiliated members access to credit facilities. The first building blocks of any MGA come from membership contributions. Depending on the country, we note that commercial partners or authorities often play a role in the further accrual of funds. In most countries

we see a considerable subsidy component in the form of reinsurance guarantees extended to MGAs via regional and national authorities.

We tend to find public guarantee systems in countries where the tradition of guilds and professional associations is less pronounced. Here too the ILO points out that this guarantee mechanism is seldom subsidy free. While critics argue that financial intervention in developing countries should be free of subsidies, the mechanisms that extend credit to microenterprises via guarantees here in Europe are all supported financially in one way or another. Obviously, considerations of a macro-economic nature and social aspects play a decisive role.

The guarantee fund of SOS Faim is dependent on permanent subsidising. Indeed, it does not pass on costs to the guarantee holders because it relies on state support. SOS Faim does not aim for a specialised guarantee fund that develops this service as an independent activity. The guarantees are an extra service provided for partner organisations that cooperate with SOS Faim. They are provided on the understanding that they will become superfluous once the organisation has accrued its own equity. SOS Faim does however point out that this objective often appears unattainable.

However, the IGF does aim to be a specialised guarantee fund, not basing its selection on a graduation of the guarantee holder. On the contrary, the guarantee holder becomes an IGF shareholder. During the discussion it was noted that this 10% basis results in a rise in costs for the guarantee holder. The IGF's screening is based

solely on criteria of efficiency in performing current activities. Since its formation in 1996 it has never sustained a loss. Over the entire period from 1985 to 2000, the experience of RAFAD included, the average annual loss of guarantees amounted to 4.5% of the fund. The interest earned by investing the fund was used to supplement the guarantees paid out, the administrative costs, and local monitoring. With a volume of around four million euros, the IGF will be able to cover its costs. At the present time the IGF is still partially dependent on subsidies. It has also managed to reinsure a substantial part of its fund through the Swiss government.

The sheer wealth of finance options creates uncertainty as to who can go where and for what. The Rabobank Foundation notes that donor organisations sometimes work against each other and do not exchange enough information. This makes it more difficult to join the commercial circuit. The Rabobank Foundation also recognises a clear problem on the side of the MFIs. There are not enough promising institutions to hand. And so the Rabobank Foundation sees a considerable challenge in developing institutional capacity, and particularly in making the move from a credit organisation to a structure of confidence.

This is a point that the others endorse, and it relates to the initial screening and further monitoring of the MFIs. They all emphasise a proper screening of the management capacity of the guarantee holder (i.e. the loan portfolio and financial situation in general) as a success factor. This management capacity is largely determined by the degree of institutional development. Organisations with a weak institutional development require extra support to develop internal capacity. The IGF is of the opinion that finding valid guarantee holders is no easy task.

Of equal importance is the further monitoring of the guarantee holder, and this is the spur for further institutional development. Monitoring fills the information void between guarantor and guarantee holder. It demands discipline and therefore better quality in the granting of credit. Not only that, but it stimulates the guarantee holding MFI to operate in conformance with the market. In this way it contributes towards a structural solution to the problem of access to credit for microentrepreneurs.

The consequences on the sustainability of the guarantee fund run deep. The set-up (assessment of creditworthiness and management capacity) and monitoring of a guarantee is an intensive labour and requires a sound knowledge of the sector. Transparency and standardised information (*rating & performance measurement*) are (still) thinly spread, making it extremely difficult to assess the debt capacity of an MFI. It will only be possible to restructure the costs on the basis of the risks run by each party (differentiated commissions and levers) once we can determine the quality of financial management in line with a given standard.

It was generally concluded that there is a need to address the lack of information on the managerial aspects of MFIs. Standard information is an essential tool for proper screening and monitoring. It ties in with the present trend for greater transparency in the microfinance industry.

At the present time, intermediary guarantee funds in microfinance are mostly not viable. Microfinance aims to provide a structural solution, and so the covering of costs is also relevant to guarantee funds. But experience in Europe shows that this mechanism is not entirely cost covering and so requires a certain level of subsidisy. Financial charges and benefits must be systematically mapped out so that a clear picture of this subsidy element can be gained, and where possible restricted or phased out.



## DISCUSSION POINT 4: What is the further role of the North?

The IGF emphasised that a guarantee fund can be built up with no exposure to the exchange rate risk. Guarantee funds are not based on a transfer of resources. The guarantee fund of the IGF remains in Switzerland, where it is invested in an ethical way. This investment portfolio represents the underlying value for guarantees in American dollars or Swiss francs. A bank in the South then provides the local organisation with a credit facility expressed in the local currency. In the event of devaluation, the value of the guarantee will not be adversely affected. Indeed, the opposite holds true. In such cases the value of the guarantee rises against the credit, which is expressed in a weaker currency. Nor is the guarantee holder exposed to the exchange rate risk. Moreover, in some countries, such as Ecuador and Rwanda, there are strict regulations governing exports of currency, which can impede the repayment of a direct loan. The guarantee mechanism is suited to measures of this type and can initiate the granting of credit, even in countries where changing one currency to another is not a simple matter. However, it is not universal. Some countries have insufficient macroeconomic stability or an uncooperative banking sector. And the fund can only be used to guarantee economic activities.

The ILO points out that the European models do not appear to be transferable to the development countries. For example the MGAs are associated with a tradition of guilds and professional associations, and are started internally on the strength of member contributions. Public guarantee systems are extremely sensitive to political pressure and susceptible to bureaucracy and corruption. The Dutch system, which rests on the excellent self-discipline of the banks, does not appear applicable in most development country contexts. A public guarantee system in a developing country would be exposed to a financial sector with countless imbalances, and thus a heightened danger of abuse.

From the floor there came the comment that guarantee funds appear only to seek leverage

over the local bank in the South. In the case of a bank in the North we assume by definition that this is not possible. On what basis therefore can we expect this from a bank in the South? The gist of the replies was that a bank in the North can only do this if it looks into the risk, which is impossible in this framework. This is certainly true for an individual case of guarantee granting. On the other hand, however, a fund can be said to form a "pool" of guarantees. Might this be a starting point for looking into mechanisms that increase the range of products from the North?

ADA is of the opinion that it will always be important to analyse whether the guarantee is the right instrument for the application. Other options should be kept open. After all, a guarantee fund leaves a major problem with MFIs unsolved, agrees SOS Faim. An organisation's lending capacity is largely determined by the level of its capital adequacy. A bank uses this ratio of solvency to determine whether it can allow extra credit. Guarantee funds cannot provide solutions for jacking up this ratio.

What came across in this discussion was the signal of caution from just about every organisation. The needs of MFIs go beyond the purely financial. Support organisations must have the capacity to identify problem areas and work out solutions. Building a guarantee fund into a range of other support services is therefore a sensible option. ■

4

# GUARANTEE FUNDS: choice of the Belgian Raffeisen Foundation

Further to this seminar the BRS decided to set up its own guarantee fund in 2002 - to which MFIs (present partners + MFIs with which BRS has not yet cooperated) would have access - in further support of the microfinance sector. The BRS aims to give a substantial impulse by depositing a sum of 250,000 euros for this guarantee fund.

The BRS views the guarantee fund as an additional instrument to support the microfinance sector. It ties in perfectly with the range of services currently offered by the BRS: finance, training and consultancy. The guarantee fund is part of the finance element, but adds to these services a tool to meet the needs of its partners. This is part of a strategy designed to support the institutional development of MFIs until they are able to continue independently.

This guarantee fund will be run under the principles of the intermediary guarantee model. Moreover, the BRS is of the opinion that a link between MFIs and the commercial financial circuit is important as a part of the overall process of institutionalising MFIs. From this perspective it has been decided to use the BRS guarantee fund solely to support MFIs in developing countries, for the loans they enter into with local financial institutions. From the seminar discussions it is clear that employment in this manner is not always the easiest way of mobilising the guarantee fund. The guarantor (BRS) finds a sound knowledge of the MFI and the local financial institution to be important. Therefore, in the operational management of its guarantee fund the BRS will call upon other existing guarantee funds with practical experience and knowledge of the field.

One major way of reducing the cost of the guarantee fund for the MFI is through the credit

leverage that can be realised with the fund. In practice these levers have turned out to be relatively small, particularly in the first stage. Nonetheless, the BRS will attempt to realise a leverage of 2.5 through its guarantee fund, in other words, the credit will be at least double the size of the guarantee sum pledged via the fund.

Another way of lowering costs for the guarantee holder is to use subsidies, which cannot be entirely ruled out in practice in any case. From the perspective of institutional development, this is not inconsistent with the objective of develo-

ping sustainable savings and credit systems. Hence the decision of the BRS to provide a subsidy component too: the BRS will provide gua-

rantee-holding MFIs with extra support to cover the costs that the intermediary guarantee fund charges the guarantee holder. This support (subsidy) will extend to a maximum of 3% of the sum issued by the BRS by way of a guarantee.

The BRS also takes seriously the issue that the banking world in the North should play a more active role. The BRS undertakes to look into mechanisms that imply extra leverage for MFIs in the South. More particularly, the BRS will investigate how leverage can also be applied to the guarantee fund in the North, and how the ratio of the deposit of 250,000 euros to the letters of credit can increase.

For more information on the guarantees provided by the BRS, please contact the secretarial department at:

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**Belgium**
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## ABBREVIATIONS

**ADA:** Appui au Développement Autonome

**BRS:** Belgische Raiffeisenstichting (Belgian Raiffeisen Foundation)

**IGF:** International Guarantee Fund

**ILO:** International Labour Organisation

**MFI:** Microfinance Institution

**NGO:** Non Governmental Organisation

**MGA:** Mutual Guarantee Association

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# EXECUTIVE SUMMARY

According to the annual report of the World Bank, 2.8 billion people, or almost half of the world population, lives on less than 2 dollars a day. 1.2 billion people have even less than 1 dollar a day! Much hope has been pinned on the sector of microfinancing as a way of helping to rectify this inequality. The Belgian Raiffeisenstichting [Raiffeisen Foundation] (BRS) supports savings and lending organisations in the South, which work on the basis of co-operative principles.

In general terms, the microfinancing sector offers financial services under certain conditions to people who do not have access to a commercial bank because of their socio-economic profile. These are poor people, with no fixed income, who can offer nothing in the way of collateral. When we refer to savings and lending organisations in this book we are talking about organisations in the microfinancing sector, which tailor their services towards the poorer populations in the South. To place the role of the guarantee fund in context, the book starts out by identifying the leading characteristics of the sector as a whole.

It is now generally accepted that under certain conditions microfinancing services can be developed with a view to financial sustainability. In recent years the microfinancing sector has witnessed an explosive growth and so it is looking for extra sources of financing. Clearly, at the financing level, the microfinancing institutions (MFIs) have received greater recognition and interest from the commercial banking sector. However, there is still a huge gulf and a lingering degree of mutual distrust. The challenge, therefore, is to encourage reciprocity in order to satisfy the demand for micro credit. In this context guarantee funds may prove to be an appropriate instrument.

Guarantee funds are hardly a new phenomenon. In the second chapter we describe the mechanism at work and give an overview of the various models to hand. We also highlight some of the strong and weak points of the guarantee fund, and distil from this the main points to bear in mind when designing a successful guarantee fund. The clarity of the objectives, the credibility of the fund, the leverage effect, the transaction costs, and containment of the risk of abuse are key elements in any guarantee fund. And yet it is still a great challenge to actually put these elements to work in practice.

This is why on 11 December 2001, BRS organised a seminar in Brussels on the use of guarantee funds within the context of microfinancing. The seminar attracted ninety interested parties from a variety of perspectives: the federal and regional governments, multilateral organisations, NGOs from the three Benelux countries, university staff, MFIs from the South, European guarantee and lending funds for development countries, and financial institutions and their associations in Belgium and the Netherlands.

The debate was confined to the intermediate model of the guarantee fund, characterised by the relationship that an MFI builds up with the formal banking sector. Though this, lending funds can flow from the banking sector to the MFIs to provide loans for micro-entrepreneurs and farmers. BRS's operations centre in on this very issue, i.e. MFIs in the South, which are in the process of institutional development.

The analysis starts out by looking at the situation of the guarantee holder, and we have taken as our example a typical MFI, the Maquita Cushunchic cooperative society in Ecuador. This co-operative society is virtually unable to make use of the local financial sector because it can offer no traditional guarantees, and can find no simple way of demonstrating its credit worthiness. This is clearly the sore spot, for the lack of trust from the formal financial sector inhibits the chances of obtaining affordable financing. The panel and audience discussed the obstacles facing Maquita, and came up with the following findings:



- **What can a guarantee fund do to strengthen the confidence of the formal financial sector?**

  It is crucial that the local bank perceives a lessening of the risk. Obviously, setting up relations between MFIs and the financial sector is no simple matter. But that doesn't make it any less important. It is a learning process that requires time, and in which we can have no expectation that confidence will rise in the short term. The spreading of the risk is the best indicator of progress. The leverage afforded by the guarantee is a point for consideration here.

- **What does it cost an MFI to use a guarantee fund and can this cost be reduced?**

  Even in hard currency, interest rates are relatively high in Southern countries. The use of guarantees inevitably brings more costs, and so is not entirely advantageous. These costs may or may not be charged on to the guarantee holder. Nonetheless, the extra costs incurred on a guarantee by the MFI are largely defined by the leverage of the sum borrowed. At the end of the day profitability will determine whether or not the MFI views the guarantee as an option.

- **Can a guarantee fund be financially sustainable?**

  Guarantee funds run into many restrictions due to an insufficient potential of sustainable MFIs. Therefore, the process of setting up (estimating creditworthiness and management capacity) and monitoring a guarantee is labour intensive, and requires a sound knowledge of the sector. Only when the quality of financial management is standardised in an MFI can we undertake the step of restructuring the costs, based on the risks run by each party. This is why, at the present time, the intermediate guarantee funds used for microfinancing do not usually cover the costs. But, from the perspective of institutional

development, this is not inconsistent with the objective of developing sustainable systems of saving and lending.

### What role can the North play in the future?

The needs of the MFIs are more than purely financial. Support organisations must be able to identify problem areas and find solutions. It is always important to make a clear analysis of whether the guarantee is appropriate to the specific need. Other options should be kept open too. The inclusion of a guarantee fund within a range of support services is therefore the obvious choice.

Further to this seminar BRS decided to provide its own guarantee fund, in 2002, in support of the microfinancing sector. BRS will deposit a sum of EUR 250,000 for this fund. The initiative is part of a range of services that BRS currently has its disposal - financing, training and consultancy. The guarantee fund falls under the heading of financing, but adds to these services an instrument capable of satisfying the new needs of its partners. This is part of a strategy aimed at supporting the institutional development of MFIs, to the point where they can continue on an independent basis.
The guarantee fund will be available to the present partners of BRS, and to MFIs with which BRS does not yet co-operate.

The basic conditions are:

- operational management via existing guarantee funds
- provision of loans by financial institutions in the country itself (South)
- minimum credit/guarantee ratio of 2.5
- maximum BRS participation of 3% in the MFI's costs

For more information on the guarantees provided by BRS, please contract the secretarial service at the address:

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## RESUMEN Y COMENTARIOS

Según el informe anual del Banco Mundial, 2.800 millones de personas, o casi la mitad de la población mundial, viven con menos de 2 dólares al día. 1.200 millones de personas viven incluso con menos de 1 dólar al día. Se espera que el sector de la microfinanciación pueda ayudar a remediar esta desigualdad. La Fundación Belga de Raiffeisen (BRS) apoya a las organizaciones de ahorro y crédito del Sur que funcionan como cooperativas.

En términos generales, el sector de la microfinanciación proporciona bajo determinadas condiciones servicios financieros a personas que no pueden acceder a los bancos comerciales por su perfil socioeconómico. Se trata de personas pobres, sin ingresos fijos, que no pueden ofrecer garantías materiales. Cuando en este libro hablamos de organizaciones de ahorro y crédito, nos referimos a las organizaciones del sector de las microfinanzas dirigidas a la población pobre del Sur. El libro empieza explicando las características más importantes del sector en su conjunto para poder enmarcar el papel de los fondos de garantía.



Ya se sabe que la prestación de servicios de microcréditos bajo determinadas condiciones puede conducir a la sostenibilidad financiera. El sector de la microfinanciación ha conocido una rápida evolución en los últimos años y, por lo tanto, está buscando más fuentes de financiación. En el ámbito financiero, el sector de la banca comercial ya ha mostrado más interés y reconocimiento para las instituciones de microfinanciación (IMF). Sin embargo, el abismo no ha sido franqueado del todo y sigue existiendo una desconfianza mutua. Por eso, fomentar la interacción para poder satisfacer la demanda de los microcréditos se ha convertido en un reto importante. Los fondos de garantía pueden ser un instrumento útil en este contexto.

Los fondos de garantía no son un fenómeno nuevo. En el segundo capítulo describimos cómo funcionan y damos una relación detallada de los distintos modelos que existen. También presentamos las virtudes y los defectos generales del fondo de garantía para así llegar a los puntos clave para el diseño óptimo de un fondo de garantía. La claridad de los objetivos, la credibilidad del fondo, el efecto palanca, los gastos de transacción y la limitación del riesgo son elementos claves para un buen fondo de garantía. Poner en práctica todos estos elementos sigue siendo un gran reto.

El 11 de diciembre de 2001, la fundación BRS organizó en Bruselas un seminario sobre los fondos de garantía en el contexto de la microfinanciación. El seminario atrajo a noventa participantes de varios sectores: el gobierno federal y regional, organizaciones multilaterales, ONG de los tres países del Benelux, colaboradores de universidades, IMF del Sur, Fondos Europeos de Garantía y Crédito para los países en desarrollo, instituciones financieras y sus asociaciones de Bélgica y los Países Bajos.

El debate se redujo al modelo intermedio de los fondos de garantía, caracterizado por la relación que existe entre la IMF y el sector bancario formal. Así los fondos de crédito del sector bancario pueden fluir hacia las IMF, para conceder créditos a microempresas y agricultores. El trabajo de la fundación BRS se centra en especial en la problemática de las IMF del Sur, que se encuentran en pleno desarrollo institucional.

El punto de partida en este análisis es la situación de la que toma la garantía y como ejemplo práctico hablamos de una IMF típica, como la cooperativa Maquita Cushunchic del Ecuador.

Esta cooperativa no puede acudir al sector financiero local porque no puede ofrecer garantías tradicionales y le resulta difícil demostrar su solvencia. Esta afirmación pone el dedo en la llaga ya que la falta de confianza del sector financiero formal dificulta la obtención de una financiación asequible. Los problemas de Maquita fueron presentados al público y a los expertos como temas de debate. Las conclusiones se pueden resumir como sigue:

- **¿Cómo puede un fondo de garantía contribuir a fomentar la confianza del sector financiero formal?**
  Es crucial que el banco local perciba una reducción del riesgo. La existencia de relaciones entre las IMF y el sector financiero no se puede dar por hecha, aunque por ello no sea menos importante. Es un proceso de aprendizaje que requiere tiempo y no se puede esperar que la confianza pueda aumentar a corto plazo. La distribución del riesgo es el mejor indicador para medir el progreso, siendo la palanca de la garantía el punto de atención.

- **¿Cuáles son los gastos de una IMF como usuario de un fondo de garantía? y ¿Cómo pueden ser reducidos estos gastos?**
  Los tipos de interés, incluso en una moneda fuerte, son relativamente altos en los países del Sur. Tomar garantías conlleva más gastos por lo que no se puede considerar como una operación totalmente ventajosa. También se podrían cobrar estos gastos al tomador. Sin embargo, el gasto extra originado cuando la IMF toma una garantía es determinado por la palanca con respecto a la oferta crediticia. Finalmente, la rentabilidad para la IMF determinará si la garantía es una opción.

- **¿Puede ser un fondo de garantía económicamente sostenible?**
  Los fondos de garantía están sometidos a muchas limitaciones porque faltan IMF potencialmente sostenibles. Tanto el establecimiento (evaluación de la solvencia y capacidad de gestión) como el seguimiento de la garantía son intensivos y requieren un conocimiento profundo del sector. Cuando como norma se puede comprobar la calidad de la gestión financiera en una IMF se puede dar el paso hacia la reestructuración de los gastos basándose en los riesgos que cada parte corre. Por eso los fondos de garantía

intermedios para la microfinanciación no son todavía al cien por cien rentables. Pero dentro de la óptica de la construcción institucional no entra en contradicción con el objetivo de desarrollar unos sistemas de ahorro y crédito sostenibles.

- **¿Cuál es en adelante el papel del Norte?**
  Las IMF no tienen solamente necesidades financieras. Las organizaciones de apoyo deben tener la capacidad de identificar las áreas problemáticas y desarrollar soluciones. Sigue siendo importante analizar la idoneidad de la garantía para una necesidad específica. La puerta no debe cerrarse a otras opciones. La introducción de un fondo de garantía en un abanico de servicios de apoyo es por lo tanto una opción sensata.

Como seguimiento al seminario, la fundación BRS decidió poner a disposición un fondo de garantía propio para apoyar al sector de las microfinanzas a partir del año 2002. La fundación depositará 250.000  para este fondo de garantía. La iniciativa se enmarca en los servicios que BRS ya ofrece: financiación, formación y consulta. El fondo de garantía entra en la división de financiación pero amplía estos servicios con un instrumento que puede satisfacer las nuevas necesidades de sus socios. Además forma parte de una estrategia que pretende fomentar el desarrollo institucional de las IMF hasta que puedan funcionar de manera independiente.

Al fondo de garantía podrán acceder tanto los socios actuales de BRS, como las IMF que no han formalizado ningún tipo de cooperación con BRS.

Las condiciones de acceso son:

- gestión operacional a través de fondos de garantía existentes
- concesión de créditos por instituciones financieras del país mismo (del Sur)
- ratio mínimo crédito/garantía de 2,5
- participación máxima de BRS del 3% en el gasto para la IMF

Para mayor información sobre las garantías que BRS ofrece, no dude en contactar con nuestra secretaría en la dirección:

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# THE ILO SOCIAL FINANCE PROGRAMME
## Finance for poverty alleviation, employment and social integration

***WHO:*** *The ILO's Social Finance Programme has three major objectives: (i) integrating financial and social policies, (ii) creating employment and (iii) reducing the vulnerability of the poor. Gender is a cross-cutting issue in the three key areas of intervention. The Programme designs and implements projects to steer financial institutions to employment and poverty reduction.*

***WHY:*** *Financial market development plays a key role in human and capital development thereby contributing to economic development. Many developing countries suffer from failures deficiencies in their financial market. The vast majority of people do not have access to capital. In a world where competition for investment prevails, developing economies must be able to offer sound financial systems, to attract their share of global financial flows and to allocate these funds in a way that promotes employment creation and economic growth. Hence, finance and financial sector issues are an integral part of employment promotion and the Decent Work agenda.*

***WHAT:*** *The Social Finance Programme has a board range of services. It responds to requests for information, advices and supports institutions, and works out to improve the access to financial services. As the ILO focal point on microfinance, the Programme has a mainstreaming function for the office, and coordinates ILO work related to the financial sector.*

***HOW:*** *The Social Finance Programme achieves its objectives by*

- *Supporting research and training by providing advisory services for private and public organizations;*
- *Managing technical cooperation projects;*
- *Disseminating information on current issues about the social dimension of finance;*
- *Representing the ILO and international fora and co-operating with other microfinance agencies.*