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Credit Guarantee Scheme for the Small Business Sector

An interim assessment after five years in Latin America

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- This paper has also been published in: New Perspectives on Financing Small Business, Ernst A. Brugger and Sarath Rajapatirana (Eds.), Switzerland, 1992.

1. Restricted Access to the Banks

Unlike the eighties, the nineties promise to be a decade of growth for Latin America. Several factors give rise to cautious optimism: the liberalization of foreign trade and exchange mechanisms; the privatization of many state-owned enterprises and the dismantling of state-imposed regulations and intervention. Together, these changes are strengthening the free market economy. The general tendency has led to numerous structural changes, the effects of which will be keenly felt by small enterprises in particular. The free transfer of foreign exchange, for example, will sharpen competition for capital resources. Deregulated foreign trade will reduce the cost of importing machines and raw materials, but will also increase competition from abroad. Overall, and in the medium term, however, the owners of small enterprises should profit most from the changes: after all, they were the ones who suffered most from the disadvantages of mercantilism and should be most favoured by current tendencies away from the old status quo. With their high innovative potential and ability to adapt to changing market circumstances, small enterprises will discover a host of new opportunities. As the stability and continuity of external factors are cemented, costs will tend to fall and productivity should increase.

Economically speaking, the role of small businesses in the growth process is very important because they are not only able to react flexibly and sensitively during periods of economic inertia but also increase competitiveness and expedite the process of industrial decentralization. In addition, they play an important socio-political role by creating more jobs and helping to distribute income more evenly.

If they are to be actively involved in this process, however, they must have access to outside capital at an affordable cost with a realistic length of time for repayment of the loan. Exactly how easy - or difficult - is it to obtain funding from the formal banking sector?

Although money lenders have traditionally granted loans for a maximum period of one year at rates six to eight times higher than normal, they are at least flexible and fast. Unfortunately, they have restricted liquidity and are thus unable to meet the demand.

Under European regulations and conditions, most small enterprises in Latin America would be able to obtain loans from the banks; i.e. they would be considered creditworthy if they had not previously been blacklisted for failure to repay a loan or protests following presentation of cheques or bills of exchange. However, if we consider that in Costa Rica in the 1980s small businesses with between 5 and 20 employees benefited from only 4% of all industrial loans while generating 25-30% of the gross industrial product (FUNDES study, 1985), it is reasonable to assume that there is a considerable shortfall in the amount of credit provided by the formal market. What this means, effectively, is that the conditions which must be met before the banks will consider a business creditworthy are extremely demanding and that most small enterprises have never managed to surmount this obstacle. Similar conclusions could be drawn about Peru, Ecuador and Panama as well as most other countries in Latin America.

Many small businesses are thus obliged to finance their own growth, which as a result is extremely slow, or to take out expensive loans with short repayment periods. In both cases the company's competitiveness inevitably suffers.

2. Where do the Problems lie?

In the past the banks have repeatedly listed the following arguments to explain their reluctance to grant credit to small enterprises:

1. The excessive unit cost per dollar loaned in view of the fact that the cost of evaluating the application, administration and collection are practically fixed.

2. The form and content of applications fail to meet formal bank requirements.

3. An unusually high degree of risk resulting from the frequency with which small enterprises fail and the unpredictability of repayments resulting from changes in the market and economy.

4. Lack of collateral, primarily real property.

5. Shortage of liquid assets to deal with new clientele.

6. Inadequate internal organization on the part of the banks, which are geared primarily to the needs of large borrowers.

The **cost factor** is certainly a valid argument. At FUNDES we too have found that the unit cost (cost per US dollar loaned) increases the smaller the loan. Nevertheless, the argument should not be overemphasized. After all, the banks charge FUNDES borrowers 3-6% more interest than their major corporate clients. In Switzerland and Germany the difference in interest rates paid by small businesses and first-class customers is merely 0.75% to 1.0% (survey carried out by FUNDES in July 1992).

We should also like to point out a number of general differences in the interest rate spread. In Switzerland, where costs are not exactly low, the spread is currently 2-2l/4%, while in Germany it is 2.5%. In countries where FUNDES is active, such as Bolivia, Colombia, Costa Rica, Chile, Guatemala and Panama, the spread at the moment is between 5 and 10%. If under these circumstances the banks complain about the cost involved in lending money to small enterprises, the real reason would seem to be their own inefficiency and the level of costs generated in-house.

In many cases they are obliged to write off losses carried forward. A study carried out by the World Bank (Bibl. 1), for example, shows that the eight year average for credit losses in Latin America is 10.4%. The same study concludes that this is due to the quality of the credit granted and to political influence. Also, the luxurious infrastructures maintained by some of the banks and the often excessive reserve demands made by the Central Banks keep costs high.

In many cases, however, the banks make their assessment of the costs involved on the basis of the single loan and ignore the subsequent advantages to themselves of having acquired a new customer. The profit on a loan to a small enterprise may indeed be low but this transaction brings the bank other more attractive business - current and savings accounts, foreign exchange, etc.

The argument that **applications are unacceptable to the banks** was more significant in the past. Today, the prevalence of finance programs for personal computers means it is no longer difficult to produce investment and cash flow calculations which are professional in appearance and contain the desired results. The problem today does not lie so much in the form or content of financial prognoses as in the credibility - or lack of it - of the figures. Checking them for accuracy when the prospective client is an unknown quantity incurs costs.

The argument that small enterprises represent **higher risk** - i.e. that they are less reliable or more likely to become insolvent - has been largely refuted. In the experience of bodies such as Accion International, Fundacion Carvajal or FUNDES itself, the owners of small and micro enterprises tend to be very reliable. They know that their creditworthiness for the next ten years depends on their meeting their financial obligations and that they are putting their entire existence at risk by not doing so. Examination of the credit portfolios of a number of private commercial banks has produced the same result. The generally negative attitude has persisted since the collapse of a number of credit schemes, which were mostly financed from abroad and implemented by national development banks. However, these were blighted by inefficiency and corruption.

While the argument that **small enterprises are unable to provide sufficient collateral** is true from an empirical point of view, it is vastly exaggerated. Small entrepreneurs often do not own any real property and the machines and goods which they pledge as security are often undervalued. This, however, is a typically Latin American problem. Using standard valuation guidelines, European banks generally require 100-120% security; in Latin America this figure is more likely to be 180-300%. The average in FUNDES programs is around 190%. By contrast with Europe, the real point of security put up in Latin America is not so much to cover the debt as to pressurize the borrower into doing everything possible to repay his debt as soon as possible. The loss of his collateral is clearly a great deal more serious than the money spent paying the loan. The explanation behind this attitude is the unwieldiness and uncertainty of the legal framework for enforcing the collection of bad debts. This in turn is largely due to the inefficiency of the administrative and legal system regarding property rights.

Today, at least, the argument that the banks have **insufficient liquidity** is rather tenuous. First, loans to small enterprises only account for an insignificant percentage of credits granted. Second, banks in most Latin American countries nowadays usually have sufficient liquid funds available. In fact, they often have a surfeit.

It is correct to say that the **internal organization** of most commercial banks in Latin America is not geared to the granting of loans under US$ 30,000 to small companies. As a rule, banks are only familiar with personal and corporate loans. Small loans to industry are generally classified as personal loans. This means that hardly any of the banks is able to say how many loans it grants to small enterprises, how profitable they are, and what costs they entail. The lack of concrete figures sustains existing prejudices concerning higher risk, lack of reliability and the inadequacy of most applications for credit. The average length of time taken by the banks which do cooperate with FUNDES - over 30 in five different countries - to process more than 1000 loan applications exemplifies the shortcomings in their efficiency:

Average time taken to process Over 1000 loan applications (in days)		
	Banks	Fundes
Feasibility study + credit application		20
Guarantee approval		4
Total		**24**
Credit approval	36	
Credit disbursement	43	
Total	**79**	

In the interests of clarity we should perhaps add that the banks required additional information for only 3% of the applications and rejected 2.8% of them. On average, less than 50% of applicants are visited by a representative of the bank.

From our own experience we know that the banks are very slow to act. Following US intervention in Panama, for example, FUNDES pushed through a crash program for 250 loans amounting to US$ 4.9 million. Processing the applications took an average of 14 days, loan approval two days, and payment 20 days. A great deal of time was saved following the introduction of new methods of registering collateral and real estate. Registration of a mortgage took an average of 30 days but overlapped with other parts of the process. The loan program for micro enterprises, which we also set up on our own initiative in Panama and has arranged 1200 loans up to US$ 10,000, resulted in 20 days for the application, three days for approval and five days for payment. In Switzerland, where applications for loans are always drawn up externally, a major bank requires an average of 14 days to approve a loan and a further six until disbursement. In Germany the figures are 14 days and ten days respectively (results of our own survey in July 1992).

We have examined the arguments put forward by the banks in such detail because ultimately we do not find them sufficiently convincing. I should now like to submit two observations of my own, which I believe come much closer to explaining the negative attitude adopted by the banks towards applications for loans from small enterprises:

1. Overall, there is far too little **competition** between the banks in Latin America. As a rule their spheres of interest are very clearly demarcated. There is no economic pressure on them to develop loans to small enterprises as a new business segment. Nor are they obliged to come up with new ideas to increase their market share or cut costs. The 'apertura' and privatization will probably bring about a swift change in the oligopolistic situation, resulting in a new status quo comparable with that in Switzerland, where competition forces even the major banks to maintain sizeable credit portfolios with small enterprises.

2. My second observation is of a more general nature and refers to the negative mental attitude towards small enterprises. In the past, credit granted to small enterprises has been guaranteed by foreign development banks, while the loan itself has usually been paid out by state-owned commercial or development banks. Private commercial banks have thus had very little involvement in these schemes. Where they have been involved, however, they have allocated the program low priority and been well rewarded for their efforts. At the same time, they have been able to improve their image by offering interest-subsidized loans to small enterprises at no risk to themselves. Small businesses, however, have never been considered as a potential new market in their own right. For this reason the banks have concentrated exclusively on **medium-sized and large corporations**. To make matters worse, commercial banks are usually part of a national group for which they organize finance. The closeness of their connections with major clients is also clear from the way in which seats on the Board of Directors are allocated reciprocally.

Overall, we believe that the lack of any real competition and the prevailing mentality are the two decisive barriers. The policy of 'apertura' should make the market more competitive, as very few banks will be able to survive from corporate banking alone. Most banks will come to rely increasingly on the small business sector for the capital they deposit in time or savings accounts, and will be obliged to expand their retail banking operations to open up the way to a broader public. As developments in developed countries have shown, these clients will also require loans from 'their' banks. If they are refused, they will go elsewhere. In future, very few banks will be able to afford that loss of custom.

Mental attitudes, on the other hand, will probably be influenced by the banks' own experiences. As soon as they start granting more loans and notice that they are in fact a useful source of income, they will discover a new, dynamic clientele in the small-industry segment, as is the case in the industrialized nations today. As a result, credit business should continue to flourish.

3. Objective and Function of Credit Guarantee Schemes

The meaning of the word 'creditworthiness' and the factors that constitute it are determined by the banks and from the point of view of the banks, most small enterprises are insufficiently creditworthy.

The general aim of credit guarantee schemes is to provide small business owners with the collateral they need to become fully creditworthy. The schemes can and will provide additional security if, to the best of their belief, an applicant has a particularly high level of creditworthiness. The collateral provided jointly by the applicant himself and the guarantee fund satisfy the bank's requirements and the loan is granted.

If these guarantee schemes are to achieve their goals, they must expedite the development process and help promote more lasting growth. The guarantees they provide will open up the additional growth potential which is latent in the small industrial sector.

By a large credit guarantee schemes in industrial and developing countries of which we are more or less familiar with about 35 - adopt one of two different approaches:

1. The selective approach

Here the fund specializes in providing the small business sector with high-risk credit for such purposes as company foundation, first loans, projects with insufficient collateral or new market and technology sectors. It also provides loans in the case of changes of ownership or special sub-sectoral risks such as excess supply and import pressure. The fund selectively filters out economically feasible projects on a case-by-case basis. Under the selective approach, there is no significant increase in the number of loans granted or in the size of the portfolio. At the same time practically all the firms benefiting from the scheme are in the genuine risk category.

2. The global approach

Here the fund guarantees loans to a specific target group - for example, small industrial enterprises with up to 50 employees - irrespective of whether the risk involved is high or low. The fund is effectively a form of insurance for creditors and results in a large increase in the size of the portfolio. The number of firms from the genuine risk group is limited and the premiums paid by the good clients cover the losses incurred on bad debts.

The following chart illustrates the difference in attitude between Latin American and European banks:

1. 100 small enterprises assessed according to criteria laid down by the Latin American banks:	
1.1. creditworthy	20 companies
1.2. not creditworthy	80 companies
Total	100 companies
2. If the 80% of companies that would not be considered creditworthy in Latin American are assessed in accordance with standards common in Europe, the following figures would emerge	
2.1. creditworthy without a guarantee scheme	50 companies
2.2. creditworthy with a guarantee scheme	5 companies
2.3. not creditworthy	25 companies
Total	80 companies

A guarantee scheme which adopts the global approach is targeted at groups 1.1., 2.1. and 2.2., in other words, 75% of all small enterprises.

A scheme using the selective approach is aimed at groups 2.2. and 2.3 and tries to filter out the 5% of good projects in the genuine risk group.

However, since group 2.1., which in our example includes 50% of all firms, has no access to bank loans, any scheme operating in Latin America should include these companies in its target group and wherever possible facilitate bank loans for both groups 2.1. and 2.2., or 55% of all small enterprises.

Any guarantee scheme must define its approach in accordance with its role in the national development process. The approach and the precise composition of the measures and/or instruments it adopts will be determined by this. The methods used to guarantee loans will also result from the way the scheme defines its role. A guarantee fund aiming merely to provide security would, for example, delegate the guarantee to the commercial banks, while a fund with selective risk assessment would always decide whether to grant guarantees itself on a case-to-case basis.

4. Results of Earlier Guarantee Schemes

We know of guarantee schemes in 11 different countries in Latin America. One has existed for over five years, is insufficiently used and shows a deficit, but it does possess sufficient assets to cover its guarantees. Another has operated for just under two years and is in a similar position. The other nine guarantee schemes have no assets left or have been closed.

All these schemes were financed by public funds from home and abroad and supervised by the respective governments. Most of them were assigned to the central banks. A sizeable proportion of the guarantee funds were never put to proper use because the banks failed to take advantage of them. The conditions which had to be met before the banks would pay out the guarantee were too demanding and generally required the liquidation and sale by auction of the borrower's business in the event of default. Liquidation could take years. By contrast, other schemes covered 80% or more of the risk and thus obviated the need for the bank to make a careful assessment of the risk involved. The schemes themselves often lacked the experience and the professionalism to subject an application for a guarantee to a proper examination. These schemes were used but soon drained of their capital as a result of too many lost guarantees. Another reason why their capital was so rapidly depleted was the unprofessional way in which assets were invested. There was insufficient diversification in the choice of investment instruments and currencies, with the result that inflation rapidly eroded the value of the assets. In some instances schemes had to be closed because, through corruption or political intrigue, guarantees had been granted to borrowers who had no intention of paying back their loans from the outset.

Negative results like these have tended to influence the attitude of the banks and international development institutions to this day. Experiences in Europe are disregarded. It is often forgotten that hardly any of the governments in Latin America at the time was adequately equipped to manage a credit guarantee scheme or any other financial program for that matter. The main shortcoming lay not in the concept but in the way it was put into practice by the public authorities.

5. The Consequences for Other Similar Projects

In view of the banks' attitudes described above and the results of earlier schemes in Latin America, we can assume that credit guarantee schemes will only function successfully if they satisfy a number of conditions:

1. They must be part of the national private sector, including the banks (management and finance).

2. There must be no restrictions regarding the origin of funds used for the scheme.

3. Income from fees and investments should cover the cost of running the scheme.

4. Guarantees must only be granted to financially sound projects and companies.

5. The guarantee scheme should have a back-up program which provides training, professional advice and other services.

6. The FUNDES Program

Although not so clearly formulated at the time, the above principles were nevertheless an integral part of the approach adopted for a FUNDES pilot project in Panama in 1984. The scheme was not intended merely to provide credit guarantees but linked the fund with a string of other non-financial measures such as management training, business consultancy, etc. It was hoped that the resultant service package would appeal to the banks and counteract many of their reservations. The aim was to cut costs, improve the standard of loan applications, reduce risk, increase guarantees and counterbalance the effect of inadequate organization. One thing FUNDES failed to create, however, was greater competition between the banks. We had hoped that based on a few, encouraging precedents, the banks might spot the future potential of this sector and want to play an active role in the nation's development. At FUNDES our main objective is - and always has been - to promote free market economies, bring about a fairer distribution of income and, ultimately, create more democracy. We wanted to set an example and perhaps create a model that would encourage large companies in other European and North American countries to implement similar schemes.

To date FUNDES has set up the following foundations:

Country	Foundation	Start of Operations	Fund Capital In US$ 1000
Panama	1984	1985	1300**
Costa Rica	1986	1987	900*
Guatemala	1987	1988	400
Colombia	1988	1989	1000
Bolivia	1989	1990	600
Chile	1991	1992	900

(*) Total capital US$ 1.9 m

(**) Total capital US$ 6.2 m

FUNDES is still a relatively young institution. If we disregard Chile, we have been active in five countries for an average of just four years.

6.1. Target Groups

The program is intended for companies in the industrial and industrial services sector with five to 50 employees, assets of less than US$ 150,000 (excluding land and buildings) and a credit requirement between US$ 7000 and 100,000. One essential prerequisite is that the owner(s) should work for the firm and derive his/their main source of income from it. Initially, our target group criteria were stricter but we have gradually widened them as it became clear that many larger companies often find it difficult to obtain bank loans. Today, FUNDES clients typically employ 12 people and take out an average loan of US$ 18,900.

6.2. Objective

At microeconomic level we hope that the financial and professional aid program will make the firms involved more competitive. At macroeconomic level, we aim to open up additional potential for growth and increase the national gross product. Firms with promising investment plans, whose owners are personally creditworthy, will be given access to bank loans. Assistance will be provided exclusively to an entrepreneurial class who have hitherto not been considered creditworthy but have succeeded in growing beyond subsistence level and who, with an injection of relatively little capital, could create new jobs.

6.3. Establishing the Fund

The guarantee fund consists of the capital put up by the foundation and other contributions. The money is used to create an inflation-proof portfolio with a healthy mix of securities and currencies. Income is used to offset the effects of inflation and, whenever possible, to create reserves. Any money left helps cover the cost of operating expenses. As a general rule, 50% of the foundation's capital is donated by companies in the country in question and the other 50% comes from companies in Switzerland. In this way, we are able to put our principle of 'helping others to help themselves' into practice.

Occasionally, contributions from development organizations give the fund a sounder financial footing.

With the exception of the pilot project in Panama, the national private sector has contributed between 30 and 70% (an average of 50%) to the fund capital. In future, the larger industrialized nations in Latin America will probably bear a larger proportion of the fund capital.

Of the six countries receiving assistance from FUNDES, four have funds which pay for themselves. Only Bolivia and Guatemala do not yet have sufficient capital. Both are short of approximately US$ 800,000 - 1.2 million.

6.4. Working with the Banks: the Approach

FUNDES and a commercial bank sign a cooperation agreement which sets out the exact procedure to be followed when a loan is granted and the terms (time and repayments). So far, we have very little experience of having to cover defaults. There has been only one case involving US$ 8000 in Costa Rica. Here the money was paid direct to the bank because it would not have been worth taking legal proceedings for the amount involved. All other guarantee payments have been made in Panama, where the economic and political crisis of 1989-90 was a critical factor. To date, however, there have been no disputes with any of the banks.

6.5. Programme Structure

CREDIT

ACTIVITY	INSTITUTE CONCERNED
Guarantee approval	FUNDES
Credit approval**	FI*
Credit contract	FUNDES, FI* & E*
Credit disbursement	FI*
Supervision and follow-up	FUNDES & FI*
Collection	FI*

ACCEPTANCE

ACTIVITY	INSTITUTE CONCERNED
Promotion	FUNDES & FI*
Diagnosis in the enterprise	FUNDES & FI*
Investment study & credit application	FUNDES FI* & E*
Services, bookkeeping, cost control and factoring etc.	FUNDES
Consultancy and training in production	FUNDES
Consultancy and training in administration	FUNDES
Association of Project users/clients	FUNDES

*) FI = Financial Institute
E = Entrepreneur

**) Occasionally banks have approved credits on condition that FUNDES subsequently agreed to provide a guarantee

6.6. Application

In practice FUNDES plays a leading role in identifying and selecting suitable candidates for loans. The banks tended to be largely passive in this respect and simply waited until they were presented with applications. The selection procedure is very stringent. In the last seven months, for example, 2100 firms have signalled their interest in a credit guarantee to the FUNDES foundations in Latin America. The following table gives details of the outcome of these applications:

Result of Applications
(7 months in 1992)

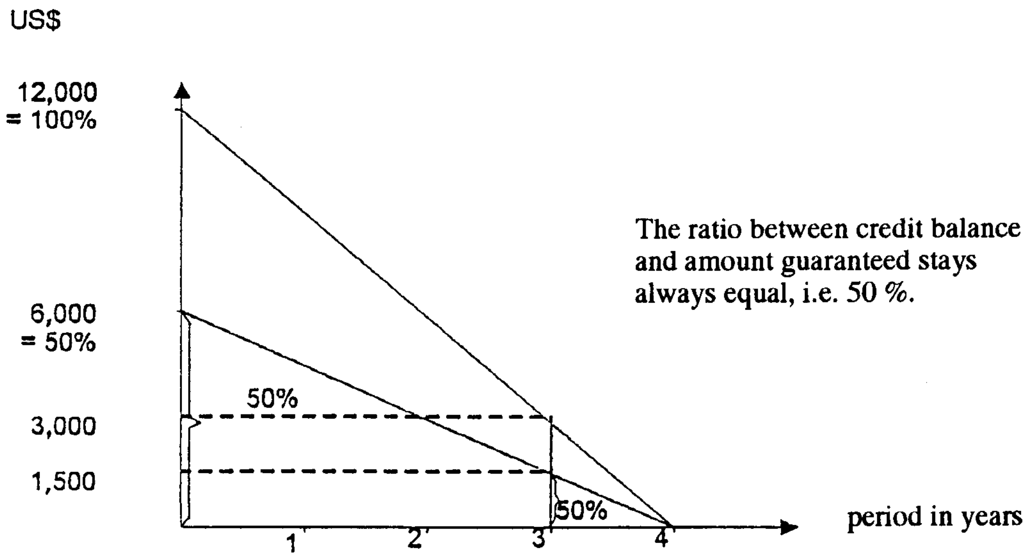
	Number	%
1. Interested firms	2100	100
2. Registered companies	700	33
1. Credit applications processed	490	23
Disbursed credits	465	22
Total rejections	1635	78
1. Other target groups:		
- Very small firms	608	38
- Commercial firms	249	15
2. Not creditworthy	599	36
3. Personal reasons	179	11

As a matter of fact 23% of all the firms interested were able to make an application with FUNDES support and 22% of the total were granted credit.

Because the bank has a great deal of trust in FUNDES, it only checks the applications superficially. This usually means ensuring that the applicant has not been blacklisted by the banks. Queries are made in approximately 3% of cases and in only 2.8% cases is the application rejected. Apart from Bolivia, where the banks visit the applicant as a matter of course, only 35% of these are visited by a bank representative

6.7. Risk Sharing and Type of Guarantee

Three partners share the credit risk. In principle the entrepreneur is fully liable and must pledge everything he owns. On top of this he usually provides additional personal collateral. If this is still not sufficient, the fund guarantees up to 50% of the sum loaned. Since FUNDES only grants an indemnity bond, which is calculated as a percentage of the final loss, the borrower, FUNDES and the bank are all under an equal obligation. The risk is shared jointly until the loan has been repaid in full. In the event of a default, the borrower's own security and personal collateral are drawn on first. Any loss remaining is borne by the fund and the bank in the agreed proportions. In the following example (see chart) the borrower stopped paying instalments after three years and attachment proved to be fruitless. The bank and the fund were thus obliged to share the loss on the agreed 50:50 basis, because the percentage which FUNDES had agreed to bear was 50%. The fund, therefore, paid US$ 1500 to the bank, which had to write off the same amount as a loss.



FUNDES tries to ensure that the bank does not demand collateral worth more than 100% from the borrower. The 50% from FUNDES comes on top of this. In practice, however, the banks tend to demand an average of 140% coverage of the loan from the borrower. All the same, this is still 70 or more percentage points below the usual figure demanded by the banks. This percentage is only reduced in the case of major clients with a solid credit standing stretching back many years.

The average level of guarantees provided by FUNDES to date is 49%. This figure, however, is strongly influenced by our pilot program, FUNDES Panama, where 70% is the usual figure. It proved to be impossible to reduce the percentage without jeopardizing the future of the entire program. If we exclude Panama, the average percentage is approximately 40%.

6.8. Costs Incurred by the Borrower

The borrower benefits from three services:

- assistance with his credit application
- a credit guarantee
- supervision and follow-up.

In return for guaranteeing loans our foundations receive between 2 and 4% of the guaranteed sum, which is equivalent to an average of 1.3% of the actual loan. A flat rate of 3.1% is charged for the application and supervision, with the sum being split roughly equally between the two services. Under the current fee structure we incur a deficit on the application and back-up services and make a surplus on the actual guarantee service. On average, however, all funds manage to cover 50% of their entire operating costs from fees. The rest is covered by income from the fund's invested capital. Under the present arrangement, the fund's financial autonomy depends on the size of its capital assets. Funds are generally self-supporting if they have at least US$ 1.2 - 1.4 million capital. In our experience the unit cost - i.e. total cost per dollar loaned - is between 0.05 and 0.31 US$, with the average somewhere around 20 cents. The huge variation in unit cost is a reflection of a sharp downward turn on the cost curve as the amount borrowed increases. By and large the program in Colombia, which has a unit cost of 0.05 US$, can be said to cover its operating costs fully and does not need its investment income. The program in Santa Cruz, Bolivia, on the other hand will have to increase its credit guarantee volume sevenfold to reach break-even point.

By contrast, the successful credit program which we introduced for micro enterprises in Panama managed to cover 82% of its costs on a unit cost of 0.24 US$ per dollar loaned. This merely serves to confirm that unit costs fall with an increase in the credit volume and that it is possible to pass on higher costs to the borrower. The crash program which followed American intervention in Panama and provided loans of up to US$ 50,000 generated a clear surplus.

6.9. Collection and Payment of Guarantees

Responsibility for collecting repayments, interest and commission lies with the banks. Because the contractual agreements regarding debt enforcement and collection procedure are very clearly defined there has never yet been a disagreement between FUNDES and the banks. However, it has become clear that in some countries the banks' internal portfolio monitoring is less than perfect and that considerable irregularities occur in the debt enforcement procedure prior to legal proceedings.

The bank can require FUNDES to pay the guaranteed sum if:

- 180 days have not elapsed since the debtor first defaulted on repayments;
- a valid enforcement order has been issued against the debtor(s);
- the credit guarantee provided by FUNDES is valid, i.e. the last commission has been paid.

In such cases, FUNDES undertakes to pay within 30 days the agreed percentage of the sum of the capital owed plus accrued interest for a period of up to six months. At the same time the bank is obliged to transfer its legal claims to FUNDES and to continue with the legal debt enforcement procedure for the entire amount. Any amount subsequently received is divided between the bank and FUNDES in accordance with the contractually agreed percentage.

Apart from Panama, there has so far been only the one guarantee disbursement for US$ 8000 in Costa Rica, mentioned earlier. This means that the loss incurred on guaranteed loans so far is 0.09%. If we include Panama, where the loss ratio is 2.88% - because the political and economic crisis of 1989-1990 effectively paralyzed the commercial banks for almost two years - the loss rate increases to 1.63%. Legal proceedings against a number of earlier debtors are currently in progress, however, and there is still hope that repayments will be made. If we exclude Panama, payment defaults amount to 2.5% of the current credit portfolio; with Panama, that figure rises to 18.5%. These figures represent a percentage of the sum resulting from the net amount owed on loans at least 30 days in arrears against the current credit portfolio (calculated strictly).

In Panama, as a result of the crisis mentioned earlier, losses were about three times as high as commission fees from guarantees, while in the remaining countries payments made as a result of losses amounted to less than 5% of commissions.

However, since we need at least five to seven years to make any conclusive assessment, we are anticipating an average loss ratio of 1 to 1.5% of the guaranteed loans.

Our initial assumption that losses would amount to about 5% was considerably overestimated, particularly when viewed in the light of the selection procedure, which places such emphasis on security and borrower standing, and the attendant guarantee ratio. Even the crisis in Panama - which was classified a "catastrophe" in insurance parlance - has so far resulted in losses of only 2.88% nearly two years after the event.

6.10. Training and Consultancy

To be successful, promotion of small companies in Latin America must be carried out responsibly. The entrepreneur must be made thoroughly aware of his obligations before his loan is granted, and the use to which the money is put along with the repayments must be carefully and constructively monitored. The time and energy involved, and our concern that we should not appear paternalistic, set limits to the amount of supervision we can realistically impose. Nevertheless, anyone who accepts a credit guarantee is obliged to cooperate with FUNDES once the loan has been disbursed. In practice we have found that almost all financial institutions in Latin America pay far more attention to the security put up by the borrower than any thing else. As mentioned elsewhere, this is used to put the borrower under intense pressure. Swiss and German banks, like FUNDES, are primarily interested in the project and the entrepreneur, although normal guarantees amounting to 100% of the loan are a prerequisite. The extreme caution of the Latin American banks no doubt results from past experience and can also be explained by the instability of enabling conditions. All the same, their methods and decision-making procedures would probably be much more flexible if they were exposed to real competition.

Advice and support with the credit application are absolutely indispensable and function smoothly. Supervision and follow-up after payment of the loan, however, are not particularly well established. Development of these aspects of our service are adversely affected by the unfortunate cost/benefit ratio. Because the FUNDES foundations are not usually able to count on support from abroad, they have to think very carefully before introducing additional services that will require subsidies. The need for business and technical consultancy services in the small business sector in Latin America is immense, and growing with the unrest resulting from 'apertura' politics. Results of management training courses held in Panama and Costa Rica, where 1300 and 350 entrepreneurs respectively received basic and further training, have been very encouraging. The schemes managed to cover 40% and 60% of their overall cost independently. We shall be devoting more attention to business consultancy services and training in future.

6.11. Results to Date

In the course of an average of four years in operation, we have granted direct loans amounting to approximately US$ 7.2 million and mobilized a further US$ 14 million by providing credit guarantees. The entire sum involved is over US$ 20 million for more than 2200 firms. Of this amount, approximately half has been granted in the past 12 months alone (these figures exclude Chile, which has not yet introduced a credit guarantee scheme). Our experience in Panama was painful but salutary. We learned what it means to live through almost two years of perpetual catastrophe and survive. We also managed to recoup our losses without touching the fund's capital. At present we manage a credit portfolio of US$ 10 million with guarantees amounting to US$ 4.9 million. If we also include the two credit schemes under our control in Panama, the value of the portfolio increases to US$ 15 million.

Our results can be summarized as follows:

Target group:	Small enterprises from industry and industrial services sector with 5 to 50 employees;
Average loan:	US$ 18,900 for fixed or current assets;
Selection rate:	22% of interested companies achieve credit; of the companies which failed to achieve credit (78%) 53% do not belong to our target group, 36% are not creditworthy and 11% resigned due to personal reasons;
Average guarantee:	49%;
Direct credits:	over US$7 million;
Guaranteed credits:	over US$ 14 million;
Actual portfolio:	over US$ 15 million;

Number of clients:	more than 2,200;
Default over 30 days:	2.5% without Panama/18.5% with Panama;
Loss of guarantees:	0.09% without Panama/1.63% with Panama;
Losses:	1 case in Costa Rica in the amount of US$ 8,000 (without Panama);
Training in management:	over 1,700 entrepreneurs;
Consultancy:	over 2,600 entrepreneurs;
Self-sufficiency:	50% (without income from capital investment)
Costs per US$ lended:	0.04-0.31

With the exception of Colombia, where the guarantee scheme was introduced just under a year ago, we have only been active in small countries. Measured in terms of defaults and capital actually lost, the scheme has been a success from the beginning. We were aware that we had much to learn and have always attached greater importance to quality than quantity. Caution is called for in Latin America and the fate of previous guarantee schemes was a warning. We have always taken care to offer firms seeking loans a complete range of services, of which the two most important components were investment advice and the credit guarantee itself. The risks involved in each project were carefully assessed, i.e. the investment study was usually drawn up under our direct supervision. Once the loan had been granted, we supplied professional follow-up. Ancillary measures, such as business consultancy and training (in management, for example), were usually available. These measures made it possible for us to control and justify the credit risk involved with statistically second-class clients, and in this way good projects proposed by firms from the genuine risk group had a real chance of being realized.

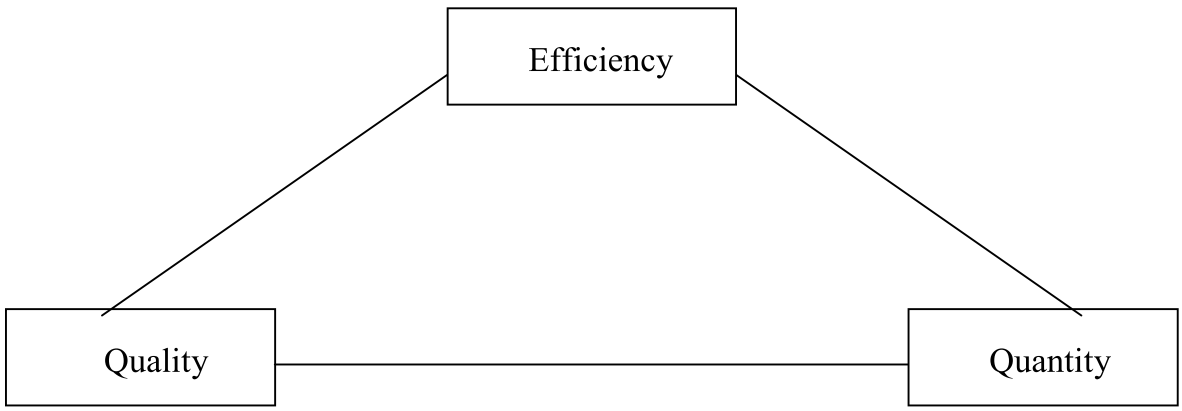
Our careful approach has enabled us to establish trust and to set certain quality standards. It has been criticized for benefiting too few people, but we believe a solid basis is essential at the beginning. Over the past 18 months or so, our strategy has started to pay off and we have been able to increase the number of people receiving assistance. All the same we believe that real success, in purely numerical terms, still lies ahead.

7. General Assessment

From the very beginning we realized that the FUNDES scheme would be a permanent learning process. It will continue as such in future. At present we are looking into new ways of increasing the quantitative effect without a significant drop in quality.

As we have already seen in Chapter 3, credit guarantee schemes adopt one of two fundamentally different approaches: the global approach or the selective approach.

We can depict the conflicting nature of these two approaches in a triangle, which proposes a means of optimizing the entire process:



Applied to the two different approaches used in credit guarantee schemes, this produces the following results:

Characteristics of Various Types of Credit Guarantee Schemes

Criteria	Guarantee principle	
	Individual/ Selective	Global
Efficiency:		
- Unit cost	high	low
- Overall cost	low	high
Quality:		
Lost guarantees and arrears	low	high
Quantity:		
Guarantee and credit volume	low	high
Proportion of additional credits Or net product	high	low

Guarantee schemes which operate on an individual selection basis and only serve clients who belong to the risk group - i.e. only make possible additional loans - generate lower credit volumes and usually require state-funded counterguarantees. A good example of this type of funding are the guarantee banks in Germany, which decide themselves whether to provide a guarantee or not and do not delegate this decision to the banks.

By contrast, funds which operate on the global principle have large portfolios and find it easier to establish their independence because the greater part of their income comes from clients who do not belong to the real risk group and additional credits only account for a small percentage of their overall portfolio. Examples of these are the Banque Populaire Group's Fonds Mutuelle in France and the guarantee fund in the Republic of China. In these cases, decisions regarding guarantees are delegated to the banks.

If we calculate the total cost involved for both approaches in terms of the amount of additional credit mobilized, the cost per US dollar loaned under the global approach is considerably higher than that incurred using the selective approach.

If we make 'additional credit' the touchstone of our overall assessment, the selective approach emerges on top. This is because, economically speaking, its margin costs are lower, i.e. it is more efficient. But how does it fare from the point of view of increasing the credit volume and making small businesses more creditworthy and significantly increasing the number of loans for the approximately 55% of all small enterprises in Latin America mentioned in Chapter 3, which have hitherto failed to persuade the banks of their creditworthiness?

FUNDES opted for the selective approach and concentrated on target group number 2.2., "creditworthy with a guarantee scheme", mentioned in Chapter 3. This, we conjectured, would enable us to offer the banks a model that would be acceptable in free market terms and yet would still allow us to check the quality and security of our clients. We had no intention of seeing the scheme fail because of losses incurred at the beginning. We assumed that the banks would develop our initial scheme more enthusiastically and would gradually make greater and greater use of our program. We must not forget either that FUNDES started in the small countries of Latin America during a period characterized by depressed economies, capital shortages, high credit losses and a general atmosphere of crisis. Yet after four years we find that our work has not yet resulted in a much higher credit volume than before. The banks are still not sending many clients to FUNDES and do not actively help to propagate the fund. At least in Central America, they seem to expect us to provide them with a steady stream of new customers who will open up new avenues for them at relatively low risk. The banks clearly do not find the FUNDES service package - i.e. the credit guarantee, consultancy, training, etc. - sufficiently attractive for them to want to start working with us on a larger scale. We have not yet succeeded in surmounting the obstacles mentioned at the beginning (costs and liquidity) nor in changing the prevailing mentality. The banks do not tend to see their work with FUNDES in terms of 'real' business. They believe they are being 'altruistic', which inevitably casts FUNDES in the role of the supplicant. Nevertheless, the very high quality of the portfolio is one of the reasons why FUNDES has succeeded in winning the trust and confidence of the banks, as the facts and figures listed earlier regarding rejected applications and the low proportion of visits by bank officials suggest.

FUNDES has also learned to make a better assessment of the risks involved in granting guarantees and loans. For us, small entrepreneurs do not constitute a risk group and the majority of them are creditworthy. However, we can only convince the banks of this if we offer them a sufficiently attractive 'low-risk, low-cost' program through which they can learn that there is a growing market with interesting perspectives. They will be introduced to a new market segment and a self-perpetuating dynamism based on supply and demand will be able to unfold.

Ultimately, this learning process will give the banks more experience and make them better informed. A guarantee scheme which operates using these principles should be able to bring about a change for the better in the banks' attitude towards small enterprises. We do not believe that the banks will alter their stance if they are offered subsidies: this has been tried in the past and failed. The 'cost' is only one of the reasons for their hesitancy and not necessarily the main one.

All this means that FUNDES will have to modify its own approach. We will thus be moving away from the selective approach towards a global one in order to reduce our unit costs and increase the credit volume as much as we need to. We will be including the large group of enterprises that would be considered fully creditworthy by European standards but are not yet considered reliable in Latin America. Only when we do this will the positive aspects of the learning process begin to have an effect. To encourage the banks to take a more active role we have to do more publicity. Possibly we will increase the guarantee cover ratio and lower guarantee charges so that the banks ask for guarantees for clients who do not belong to the real risk group. A typical case might be a thoroughly trustworthy client who requires a five-to-six-year loan, but who represents a risk unacceptable to the bank because of the relatively long period required for repayment. It is also conceivable that FUNDES could shoulder the responsibility for debt enforcement and collection and thus relieve the banks of this unpleasant duty. We should also aim to shorten the time required by the banks to approve and disburse loans. A delay of 75-80 days is frustrating for the applicant and damaging to our reputation. Perhaps the credit decision can be delegated to the bank.

The question of more selection - and thus the greater economic efficiency that would result from concentrating on granting more credits and thus in creasing the value of the portfolio - is one that should not be addressed until we have achieved a much higher credit level than at present and have been functioning satisfactorily for a period of about ten years.

But what is the right combination of instruments? Which are the supervision and quality control mechanisms and which is the right procedure for the credit decision? How should the loan approval procedure be organized? Who decides what guarantees and how much follow-up will be necessary? All these are questions to which we do not yet have the final answers.

We remain convinced that credit guarantee schemes for the small business sector are a healthy feature of market economies. Present developments in Europe, particularly in Spain, Italy, France, Germany and Belgium are ample proof. Nevertheless, the funds still depend on the cooperation of the banks. If cooperation fails to produce reasonable results, we will perhaps be obliged to seek new partners. Alternatively, new credit institutions will have to be founded. Encouraging examples of credit institutions which specialize in the needs of micro and small companies exist. Ultimately, it must be possible, as is the case in the industrialized nations, for a small, economically sound company to obtain credit for a worthwhile project.

Even if private initiators of guarantee schemes do not have state support, it should be possible to do the job with private means. At FUNDES, we are about to embark on the next stage in our journey of discovery. We know that many more stages lie ahead. But we also know that like any free-market mechanism our small enterprise promotion scheme will become more efficient in the process.

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