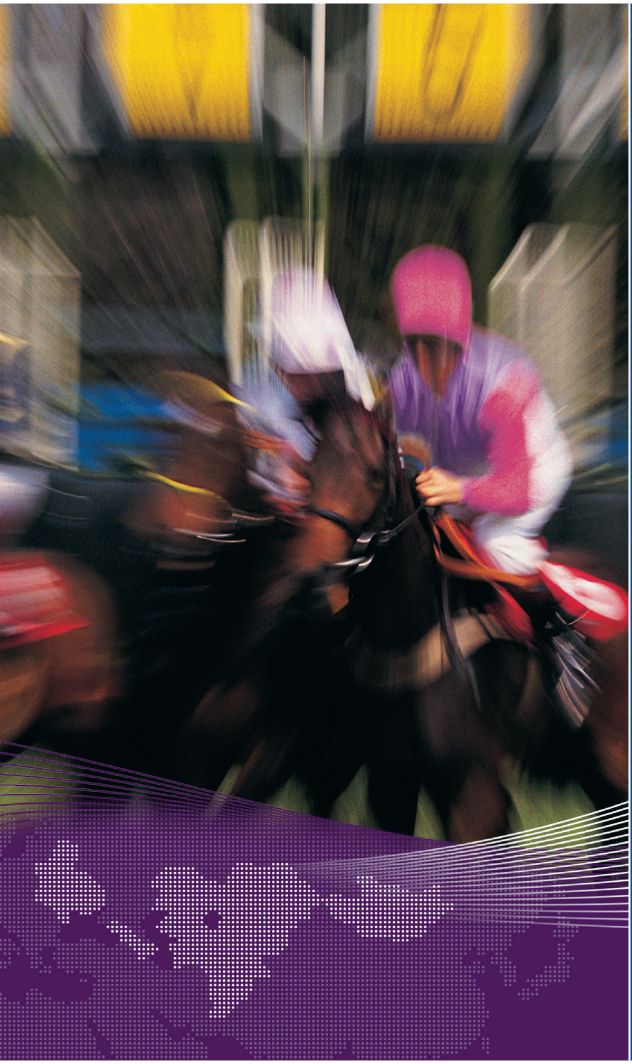
PRIVATE SECTOR DEVELOPMENT

Policy Handbook



Improving Access to Finance for SMEs in Central Asia through Credit Guarantee Schemes

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PRIVATE SECTOR DEVELOPMENT POLICY HANDBOOK

Improving Access to Finance for SMEs in Central Asia through Credit Guarantee Schemes

- INVESTMENTS AND COMPETITIVENESS IN CENTRAL ASIA -

MAY 2013

The OECD Central Asia Initiative

Launched in November 2008, the OECD Central Asia Initiative is part of the OECD Eurasia Competitiveness Programme, which aims to contribute to economic growth in Afghanistan, Kazakhstan, Kyrgyz Republic, Mongolia, Tajikistan, Turkmenistan and Uzbekistan. Its objective is to share with the governments of the region the knowledge, experience and good practices of OECD countries to create a sound business climate for investment, enhance productivity and support entrepreneurship, develop the private sector, and build knowledge-based economies to render its sectors more competitive and attractive to foreign investment. Its approach comprises both a regional policy dimension, which entails peer dialogue and capacity building, and a country-specific aspect supporting the implementation of a number of prioritised reforms. A sector analysis is also included, covering the formulation of targeted policies and strategies requested at the industry level. Within the framework of the programme, public authorities, the private sector and civil society within these countries have been engaged in a dialogue and collaborative process to support policy actions and identify key barriers to competitiveness.

The participation of all stakeholders in the reform process, including foreign investors, is considered to be crucial for guaranteeing the effectiveness and transparency of the recommended policies.

FOREWORD

Since 2009, the OECD Eurasia Competitiveness Programme has worked with the governments of the Central Asia region to create a sound business climate for investment, enhance productivity, support entrepreneurship, develop the private sector, and build knowledge-based economies to render this region more competitive and attractive to foreign investment.

In a first step, this work has led to the development of a Competitiveness Outlook for Central Asia which was launched in January 2011 in Davos, Switzerland. The Competitiveness Outlook identified barriers that need to be dismantled for Central Asian economies to reach their full potential. It highlighted three major challenges to improving competitiveness: a deteriorating education system which is undermining the future of the region's human capital; a lack of access to finance for small- and medium-sized enterprises; and a need for better investment policy and promotion.

In a second step, building on these findings, the OECD in close collaboration with the economies of the region developed potential strategies to overcome these obstacles by focusing on one specific policy tool within each of these three areas. This handbook contains the conclusions related to access to finance for SMEs and provides guidance for policy makers on establishing and operating credit guarantee schemes (CGSs) as an effective measure to facilitate access to finance for SMEs in Central Asia region. Currently, only three Central Asian countries – Afghanistan, Kazakhstan, and, more recently, the Kyrgyz Republic – have a CGS in place; in Mongolia, a CGS is being established but not yet operational. Countries from Central Asia could leverage international experience and good practice in credit guarantee schemes to further support access to finance for SMEs in the region.

Unless otherwise specified, this policy handbook is based on the proceedings of the OECD Working Group meeting on Access to Finance *for SMEs in Central Asia, held 18-19 September 2012 in Istanbul, Turkey, with the participation from all the countries of the region. It builds on a preparatory self-assessment questionnaire "Access to Finance for SMEs in Central Asia" completed in 2012 by all the participants and an independent assessment of the financial environment conducted by the OECD.*

The project was conducted in close collaboration with policy makers from the Central Asia region and was financially supported by the European Union.

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The policy handbook was written under the guidance of Anthony O'Sullivan, Head of the Private Sector Development Division (OECD DAF/PSD) and Antonio Somma, Acting Head of the Eurasia Competitiveness Programme (OECD DAF/PSD).

Strategic oversight was provided by the Co-Chairs of the OECD Central Asia Initiative, the European Union and France, by the Co-Chair of the Access to Finance Working Group for Central Asia, Czech Republic (Vlastimir Tesar, Director, Department of Multilateral Economic Relations, Ministry of Foreign Affairs of Czech Republic), as well as by OECD Deputy Secretary-General Richard Boucher.

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The project was co-ordinated by Daniel Quadbeck (OECD DAF/PSD) and Claire Burgio (OECD DAF/PSD), with the support of Marina Cernov and Esther Somfalvy. Project implementation was assisted by Elisabetta Da Prati, Orla Halliday, Anna Chahtahtinsky, Jolanta Chmielik, Renata Helliot Tavares and Lynn Whitney (all OECD DAF/PSD).

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Acronyms and abbreviations

AMFOT	Association of Microfinance Organizations of Tajikistan
CGS	Credit guarantee scheme
DAMU	Entrepreneurship Development Fund, Kazakhstan
DEG	German Investment Corporation
EBRD	European Bank for Reconstruction and Development
EU	European Union
GDP	Gross domestic product
ICT	Information and communications technology
IDA	International Development Association, World Bank
IFC	International Finance Corporation
IMF	International Monetary Fund
KfW	German Development Bank (Kreditanstalt für Wiederaufbau)
MFI	Monetary financial institution
SBLA	Small Business Loans Association, Canada
SME	Small and medium-size enterprise

Executive summary

Access to finance for SMEs in Central Asia is limited, with commercial banks and other lenders generally viewing SMEs as high-risk borrowers. Consequently, small companies from the region often face high interest rates and collateral requirements that they are unable to meet. This handbook provides an overview of international experience and good practices in credit guarantee schemes (CGSs), which are risk-sharing tools that aim to enhance access to finance for firms lacking collateral. Current practices in Central Asia are reviewed and guidelines on their establishment and improvement are provided based on the individual situation in each country from the region.

Access to finance is a major constraint for SMEs in Central Asia

Despite SMEs' recognised role as a source of employment in Central Asia, their contribution to GDP is low, varying between 1.3% and 54% of GDP compared to the OECD average of 55%. This untapped economic potential results from a variety of obstacles to SMEs' growth and development, including limited access to finance.

In particular, weak regulatory frameworks, limited bank financing and few financing alternatives for start-ups and young SMEs are major obstacles to SME financing in Central Asia, as confirmed through a survey conducted by the OECD as part of the first *Central Asia Competitiveness Outlook* that assessed the government and private sector perception of access to finance policy frameworks in all Central Asian countries (Afghanistan, Kazakhstan, the Kyrgyz Republic, Mongolia, Tajikistan, Turkmenistan and Uzbekistan).

Banks, the traditional source of funding in Central Asia, are reluctant to provide loans to SMEs due to the high perceived risk associated with SME lending. Only 20% of small firms and 27% of medium firms in Central Asia use bank loans as a source of business financing. This reluctance stems from the assymetry of information, i.e. lack of relevant credit and financial information on SMEs, and limited or lack of adequate collateral. At the same time, few financing tools exist outside the banking sector to support SME financing.

Central Asian countries could leverage international experience in credit guarantee schemes to improve access to finance policies in the region

International experience suggests that credit guarantee schemes (CGS) can help improve lending to SMEs by outsourcing part of the risk to a third party, i.e. a credit guarantee facility which provides an insurance for banks against loan default in exchange of a fee. In case of default, the lender recovers the value of the guarantee provided by the credit guarantee facility. The advantage of such a mechanism is that it allows SMEs with insufficient or lack of collateral but with high cashflow potential to access formal bank credit. As a side-effect, by working with SMEs, the banks can gradually develop expertise in assessing their risk and specialise in lending to the SME sector.

When setting up a credit guarantee scheme, Central Asian governments would benefit from looking at international experience to take into account lessons learned from both successful and failed schemes in other countries. For example, experience shows that it is important to clearly define the mission of the guarantee scheme to reduce the conflict of interests between the guarantor and lending institutions participating in the management of the guarantee scheme. Furthermore, schemes were particularly successful when the lending institutions were actively involved in the evaluation of the SME risk, allowing the banks also to gain expertise and spcialise in SME lending (e.g. in Chile). To increase the positive impact on the SME sector, the CGSs could also target a specific sector or group of firms (e.g. in Lithuania). Finally, conducting impact analysis and monitoring the beneficiary firm's business development is crucial to assess the tool's effectiveness and adjust its mechanism, if required, to achieve a higher impact.

While CGSs can be useful in addressing specific market failures related to SME lending, the establishment of a sound regulatory environment remains a precondition for the efficient operation of the financial markets. For example, an efficient financial market will regulate and reduce the information asymmetries between the parties through rules of accounting standards and credit information bureaus. At the same time, effective collateral regimes, i.e. well drafted and enforced laws on property rights and bankruptcy procedures, will contribute to SME finance by reducing the risks and potential losses for lenders when providing loans based on collateral. Improving these policies should be a priority for policy makers to enhance SME financing.

Credit guarantee schemes operating in Central Asian countries should be reviewed and revised periodically in the light of new experience

Currently only three Central Asian countries – Afghanistan, Kazakhstan, and, more recently, the Kyrgyz Republic – have a CGS in place; in Mongolia, a CGS is being established but not yet operational. The schemes in Afghanistan and the Kyrgyz Republic were established with the help of foreign donors and are operated as private, not-for-profit institutions. The credit guarantee scheme in Kazakhstan was established as a government initiative, while in Mongolia as a public-private partnership.

The four countries in Central Asia with a credit guarantee scheme in place or under development should ensure that the schemes are regularly reviewed and revised in the light of new experience and international good practice. In addition, based on the specific situation of each country, policy makers could consider the following guidelines:

Afghanistan

- Leverage the experience of the already existing CGS, which has a longer operating record (since 2005) than other CGSs in the region and has achieved good results. This could be done by organising capacity building seminars with experts from DEG, which operates the schemes, and share experience on how to address policy barriers specific to Afghanistan such as an underdeveloped financial sector and a limited number of potential partner banks.

- Consider contributing to the existing or new credit guarantee schemes to reduce the dependency of the country on donor funds.

Kazakhstan

- Expand the scope of the existing scheme. The scheme should consider expanding the number of guarantees provided and target more firms from other important sectors of the economy such as agriculture and ICT. The expansion of the scheme would also entail building competences for servicing SMEs in these sectors.

- Simplify the guarantee approval procedure in the current scheme to reduce the time and costs for the banks and for the borrowers. Reduced costs will also encourage banks to provide more loans based on guarantees.

- Strengthen the governance and risk management of the CGS by reducing the public sector's involvement in the decision making process.

Kyrgyz Republic

- Set up a legal framework for regulating loan guarantee activity. National legislation on guarantees will allow the expansion of guarantee funds at a national level, which could also attract more funds and allow the financing of small to medium-scale investment projects.

- Expand the fund activity through wider geographical coverage and by increasing the share of guarantees provided to higher value-added sectors, including manufacturing and services.

Mongolia

- Ensure a qualitative risk management and governance of the newly established CGS by minimising the political interference in the decision making process.

- Ensure a wide economic outreach to SMEs in rural areas by co-operating with banks and non-bank financial institutions with a large geographical coverage or by setting up regional branches of the guarantee fund.

Countries that do not yet have a CGS in place could consider starting with a pilot project based on international good practice

Tajikistan, Turkmenistan and Uzbekistan do not yet have a credit guarantee scheme in place, but are considering the establishment of a scheme in the future. In Tajikistan, a CGS will be established based on the Afghan experience, with the support of DEG. This will allow taking into account lessons learned in setting up the optimal scheme. When setting up a CGS, policy makers in these three countries could consider the following guidance:

- To ensure the efficient operation of CGS, it is important to first strengthen the regulatory framework for property rights. Weak property rights remain a major obstacle to the development of the financial system and CGS as they limit the efficient use of collateral in financial transactions. For example, in Tajikistan lending to small businesses continues to be hampered by the lack of transferable land-use rights. In Turkmenistan, despite direct lending from the state, banks can still request collateral which, in the absence of clear property rights, is a major obstacle to SME lending. In Uzbekistan, access to financing of SMEs is limited due to the lack of full land property rights for farmers.

- Market liberalisation is another important factor for a more efficient financial sector. Significant government interventions in the form of subsidised interest rates and direct lending distorts competition and credit allocation.

- As a second step after taking into account these initial recommendations, Tajikistan, Turkmenistan and Uzbekistan could consider setting up CGS to further facilitate access to finance for SMEs. As Tajikistan is planning to establish a new scheme with the support of DEG, setting the mission and the target group of the new scheme and ensuring a qualitative risk management for the new initiative should be a priority. Turkmenistan and Uzbekistan could consider establishing a CGS based on international good practice with public support but minimal public sector interference in the guarantee selection and risk management.

Chapter 1

Access to finance fo SMEs and baseline situation in Central Asia

Despite the recognised role of SMEs in the economies of Central Asia, limited access to finance remains an obstacle to SME growth and development. Banks are reluctant to provide credit to SMEs due to a higher perceived risk and lack of collateral to cover this risk. In the context of an underdeveloped financial system in most of the Central Asia countries, SMEs have limited financing alternatives outside the banking sector. This chapter provides a brief overview of the SME financing gap and analyses the role of SMEs in Central Asia.

Access to finance is a challenge for SMEs

SMEs have less access to finance compared to large firms. Banks, the traditional source of funding, are reluctant to provide loans to SMEs due to a higher perceived risk, which stems from information assymetries, i.e. lack of relevant credit information on SMEs, and limited or lack of collateral. High transaction costs associated with the limited scale of lenders or limited products tailored to SME needs also negatively affect SME lending.

Assymetry of information constraints the ability of banks to assess SME risk

The high risk associated with SME lending stems first of all from information asymmetries between bank and borrower. SMEs are not required to disclose information and often lack capacity to produce adequate financial reporting resulting in limited information available for the bank to take an informed lending decision. As banks cannot adequately assess the risk and expected returns of the loan they either charge a risk premium or deny the loan. Improving the flow of information between SMEs and lenders could contribute to ease SME lending.

The financial system and its various components have the role to regulate and reduce the information asymmetries between the parties. For example a credit information bureau will improve creditors access to the borrowers historical credit behaviour, while accounting standards ensure greater transparency and reliability of financial accounts. Improving financial literacy and the entrepreneurs' capacity to report to financial institutions can further improve the information exchange between bank and SME. Lack of skills of bank staff to assess SME risks can also be an obstacle to SME lending.

Lack of adequate collateral hampers SMEs' access to credit

However, as information asymmetries persist, banks have to lend based not on expected return but on the ability of SMEs to pledge collateral to cover the risk.

Effective collateral regimes will contribute to SME finance by reducing the risks and losses of lenders when providing loans based on collateral. Reliable and properly enforced bankruptcy laws, property rights, creditor's rights, collateral registration are thus important elements to encourage banks to lend based on collateral and to ensure creditors' claims on assets in case of default.

Nevertheless, a number of creditworthy SMEs will still not receive a bank loan because they lack collateral or have collateral that cannot easily be assessed by banks (e.g. intellectual property). In such cases, credit guarantee schemes, equity finance and other instruments which target firms with high cashflow potential could help to provide easier access to finance.

Baseline situation in Central Asia

Despite the recognised role of SMEs in the economies of Central Asia, limited access to bank credit remains and obstacle to SME growth and development. In the context of an underdeveloped financial system in most of the Central Asia countries, SMEs have limited financing alternatives outside the banking sector.

SMEs play an important role in Central Asia

SMEs play an important social role in Central Asia and have a large economic potential. Currently, SMEs are an important source of employment in the region, although the share in employment significantly varies from country to country. SMEs employ 22.3%[1] of the workforce in Kazakhstan and 14.8%[2] in the Kyrgyz Republic. SME contribution to GDP remains low. Estimates vary across Central Asia from 1.3% of GDP in Afghanistan[3] to more than half of GDP in Uzbekistan[4] based on official statistics, compared to the OECD average of 55%.

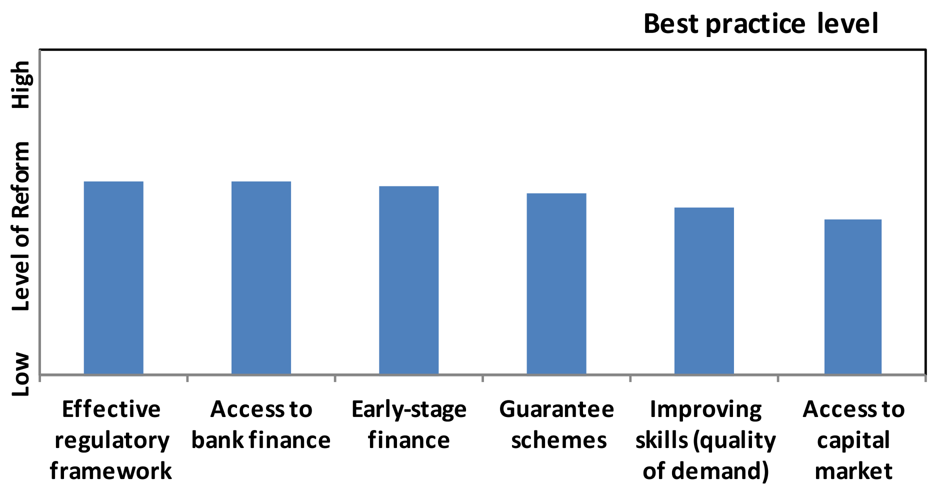
Official figures often underestimate the contribution of SMEs to the economy due to the large informal sector in the region. A large number of SMEs, often agricultural households, operate informally, and are therefore not included in national statistics or covered by state support schemes. Nevertheless, they form an integral part of Central Asian economies. For example, in the Kyrgyz Republic, according to the National Statistics Committee, the shadow economy has grown more than 18-fold between 1995 and 2007, reaching almost half of GDP[5], while in Kazakhstan it is estimated to reach 20%. In both cases, independent experts say that the real size of the informal economy is much higher than officially stated. Informally operating SMEs need to be encouraged to move to the formal economy so that their employees can benefit from state support schemes and social services (e.g. social security, medical insurance). Reducing the informal economy would also help to increase tax revenues and ensure fair competition with other firms that operate formally.

Lack of qualitative and up to date data remains an obstacle to a better understanding of the SME sector in the region. Some statistics, such as contribution of SMEs to GDP, are not collected by Central Asian countries. If data is available, it often lacks detail and international comparability. Collecting better data on SMEs would be crucial to better understand the needs of the sector and to develop more targeted support measures. Reducing the informal sector, by encouraging SMEs to formalise their economic activities would also lead to more accurate monitoring.

Limited access to finance for SME in Central Asia remains a major constraint

Despite their recognised role in the economy, SMEs still face a number of obstacles to growth and development, especially in obtaining access to financing. In the first *Central Asia Competitiveness Outlook* (OECD, 2011) the OECD conducted an assessment on the level of reforms in access to finance policies based on the government and private sector perception in all seven countries. The assessments of both the government and the private sector indicate that there is room for improvement in a number of policy measures (Figure 1.1). Major obstacle to SME growth have been identified as weak regulatory frameworks, limited access to bank finance and few other alternatives for financing start-ups and young SMEs.

Figure 1.1. Perceived level of reform of access to finance policy area in Central Asia

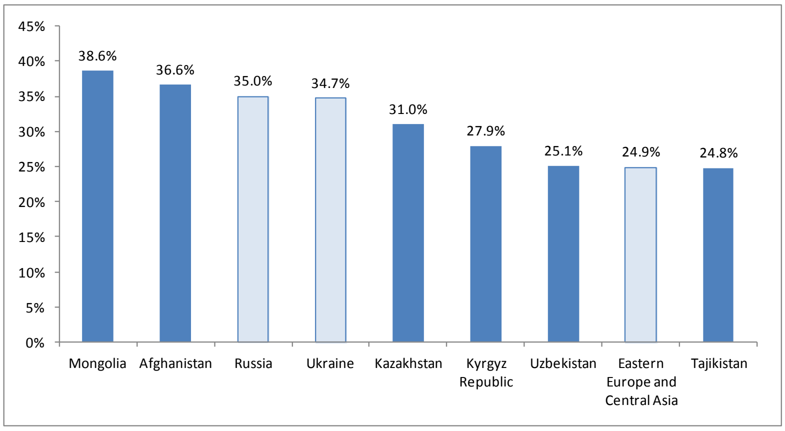


Note: "Best practice" represents the benchmark used in the Policies for Competitiveness surveys which corresponds to the OECD best practice. High represents a level of reform that meets best practice, low a lack of reform.

Source: OECD (2011), Competitiveness and Private Sector Development: Central Asia 2011 Competitiveness Outlook, OECD Publishing. doi: 10.1787/9789264097285-en

Business surveys confirm that access to finance remains a key challenge in Central Asia. According to the latest 2008-2009 EBRD-World Bank Business Environment and Enterprise Performance Survey (BEEPS), which covers all Central Asian countries except Turkmenistan, access to finance is perceived as a major constraint by firms in Mongolia, Afghanistan and Kazakhstan (Figure 1.2.). Access to finance is also listed as a top obstacle for private sector firms in the Kyrgyz Republic, Uzbekistan and Tajikistan.

Figure 1.2. Firms identifying access to finance as a major constraint (%)



Note: Data on Turkmenistan is not available; the Eastern Europe and Central Asia figure is based on the World Bank Enterprise Survey definition of the region.

Source: EBRD-World Bank Business Environment and Enterprise Performance Survey; 2008-2009 data.

Banks are the main source of external financing in Central Asia

Although bank lending remains the main source of external financing for firms of all sizes, very few SMEs have access to bank credit to finance their investment. Banks in Central Asia remain reluctant to lend to small firms due to a higher perceived risk and high transaction costs for the bank. This is also reflected in the BEEPS survey 2008-2009, which shows that only 20% of small firms and 27% of medium firms in Central Asia use bank loans as a source of financing for their investments, as opposed to 42% of large firms.[6] Moreover, bank lending in general has been affected by the financial crisis, thereby further constraining the availability of bank resources for SMEs in all Central Asia countries, except Mongolia where credit has increased as a result of the mining boom (Table 1.1.).

Table 1.1. Bank credit to private sector as % of GDP, 2008-2011

	2008	2009	2010	2011
Afghanistan	8*	9*	10*	5*
Kazakhstan	46	49	37.2	36*
Kyrgyz Republic	13.6	12.5	12.4	...
Mongolia	43.5	43.9	44	53*
Tajikistan	26.4	25.5	14.3	...
Turkmenistan	15	16.7	...	...
Uzbekistan	15	16.7	...	...
OECD members	**153***	**164***	**161***	**156***

Note: Due to very limited data availability, the information on bank credit to the private sector is compiled from two sources; data from World Bank/ World Development Indicators database is marked with *.

Source: EBRD (2011), Transition Report 2011. Crisis and Transition: The People's Perspective, EBRD; World Bank/ World Development Indicators database, last updated 28 September 2012.

Few other funding options for SMEs exist

Aside from borrowing from banks, SMEs in Central Asia have few options to finance their business. Microfinance and credit unions are some of the most popular sources, particularly among microfirms. However, the market for non-bank financial instruments, such as bond and equity financing, is underdeveloped. Stock markets are generally dominated by large firms and unreachable by SMEs due to compliance standards in accounting.

Some governments support SME access to finance through measures such as subsidised interest rates (Kazakhstan, the Kyrgyz Republic and Mongolia), direct loans (Kazakhstan, Kyrgyz Republic and Uzbekistan), and tax exemptions (Kazakhstan, Mongolia and Uzbekistan). These measures typically target specific sectors of the economy in order to support their development. While helping some firms in the short-term, these instruments tend to distort competition in the market, and should therefore be used with care.

Chapter 2

Leveraging good practices to design and manage credit guarantee schemes

Credit guarantee schemes are a popular policy instrument to facilitate SME access to finance both in developed and developing countries. Their aim is to cover part of the loan's default risk and hence motivate lenders to extend credit to groups that would not have access to finance under normal circumstances. Its success however often depends on the design and adaptation of its mechanism to local needs and objectives.

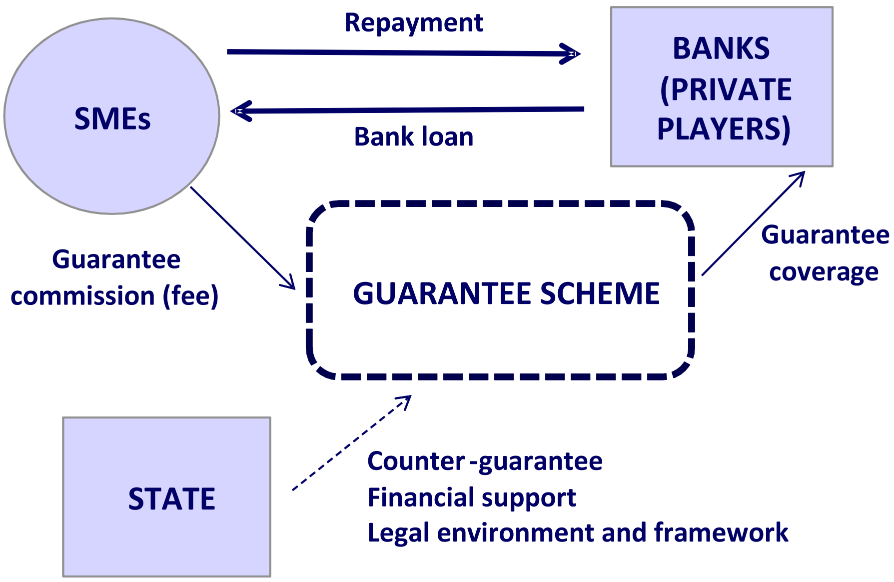
Chapter 2 provides an overview of how CGSs work, their main design features and international good practices. It also provide a brief description of existing CGS assessment methods.

How credit guarantee schemes work

A CGS covers a share of the default risk for credit given to a borrower that would otherwise not get access to affordable credit due to a high perceived risk or insufficient collateral. In case of default, the lender recovers the value of the guarantee provided by the credit guarantee facility.

The process typically starts with the submission of a loan application from an SME to a lending institution (Figure 2.1). The application is assessed and processed by the financial institution, which then applies for a loan guarantee to the credit guarantee facility. If approved by the CGS, a loan guarantee is then issued to the lender covering all or part of the loan, which is then extended to the SME. In the event that a borrower defaults on loan commitments, the lender submits a claim to the CGS to recoup all or part of its losses.

Figure 2.1. The functioning of a CGS



Source: Financial Services Authority (2005), "A Framework for Guarantee Schemes in the EU: A Discussion Paper", HM Treasury, London.

The CGS levies a fee for this service, which is intended to cover the administration costs plus the perceived default risk. Fees can be levied on the borrower, the lender or both either upfront or as a series of annual charges over the life of the loan, or a combination of both.

CGSs present several benefits

CGSs have been in use for many years in OECD countries, and have been adopted in a wide range of emerging economies from the late 20th century onwards. Until now there were many successful examples as well as failed schemes. Both have provided useful insight into the benefits and pitfalls of CGSs. The benefits can be summarised as follows:

- CGSs are useful tools to direct credit towards groups of borrowers that are creditworthy but would not otherwise receive a loan due to insufficient collateral or credit history information.

- CGSs can be an incentive for banks to enter a new market and develop required expertise without high risk. While initially being attracted by the guarantee scheme, banks can gradually develop expertise and specialise in lending to the SME sector. By working with a guarantee scheme banks may also be encouraged to open more branches to reach a larger number of SMEs.

- A CGS also enables banks to expand their portfolio as a result of the leverage effect which allows providing more credit than capital available as a result of the lower risk. Leverage ratios in a number of European schemes are around ten (including Turkey's scheme), meaning that around ten units of guarantees have been issued for each unit of capital in the fund. In some cases (including Germany, Austria and France) leverage ratios are even higher than this (OECD, 2012c).

Potential pitfalls also need to be monitored

The failure of a number of early attempts to establish credit guarantee schemes in the developing world (notably in the 1980s), has prompted criticism (Levitsky, 1997). CGSs in Malaysia, India, Korea (Levitsky, 1997), and Côte d'Ivoire (Balkenhol, 1990) have proved to be unsuccessful, after failing to put in place suitable procedures or adequate staff for handling claims for payment of guarantees. Major pitfalls can be summarised as follows:

- Critics point out that part of the lending under these schemes would probably have taken place anyway, with lenders simply taking advantage of the lower risks involved to increase their profits. Banks and other financial institutions might, for example, simply move some of their existing lending into the scheme (assuming they qualified) and then expand lending to other, non-priority borrowers (so-called intra-portfolio substitution). Banks enrolled in the CGS might also have been able to capture business from non-enrolled institutions that were already lending to the SME sector without generating any significant increase in overall lending to targeted businesses. The effectiveness of a CGS can also be undermined by the problem of getting lenders involved in the scheme in the first place.

- Other critics focus on the additional costs that are likely to be incurred. These include additional administrative costs of participation incurred by the lending institutions, the cost of setting up the scheme and the cost of financing the guarantees. In many cases, these costs are likely to be passed on to borrowers, offsetting the benefits of lower interest rates. Adding another administrative layer to the lending process might also increase the time required to secure loans.

- Furthermore, CGSs may also increase moral hazard of both borrowers and lenders. Knowing that their loans are guaranteed, borrowers might not feel obliged to repay the loan, as losses will be absorbed by the guarantee agency. For their part, banks might be more lax in their screening and monitoring of applications as a result of the lower risk resulting from the guarantee. The failures in the set-up of a guarantee scheme are sometimes apparent only after several years.

Many of these problems afflicted early versions of CGSs and accounted for their limited or complete lack of success. However, many of them can be eliminated or reduced through better design and implementation of CGS schemes. Moreover, some early scheme failures were more the result of wider systemic deficiencies, such as problems with the legal system, inadequate registration of collateral assets, and political interference from governments pursuing different objectives, rather than deficiencies in the CGS itself.

Key elements to consider when designing and managing a credit guarantee scheme

Credit guarantee schemes can differ on fundamental design features, such as eligibility criteria, coverage ratio, fees and payment rules. These differences reflect to some extent local conditions and different objectives of the scheme. On the basis of past experience, the OECD identified six key features to be taken into account in designing and managing a successful CGS (OECD, 2012a). These are the scheme's mission, targeting, funding (including the involvement of private players), pricing, risk management, regulation and governance (Figure 2.2).

Figure 2.2. Six key elements in the design and management of a CGS

Source: OECD (2012), *Implementing Credit Guarantee Schemes in Ukraine: The Case of Agribusiness*, OECD, Paris.

Relevant stakeholders need to agree on a clear mission

Public and private players participating in the scheme need to reach an agreement on the mission with clear objectives that reinforce the fact that the CGS has to: i) support credit-constrained SMEs and, as much as possible, avoid lending to firms that would have received a credit even without a guarantee, ii) focus on the economic sectors with the greatest needs and iii) be financially sustainable over time. Given the constraints on state budgets this element is particularly important for Central Asian governments.

In some countries credit guarantee schemes are used to substitute for the inefficient financial market, such as lack of legal provisions for using movable assets as collateral etc. In this case, reform efforts of the legal and regulatory framework should be a priority, as it is the underlying obstacle to accessing finance.

Determining a set of eligibility criteria would help in targeting credit-constrained SMEs

A successful CGS needs to include eligibility criteria that target credit-constrained SMEs: existing market players (*e.g.* banks, credit unions) could be involved in determining a clear set of eligibility criteria, which would allow the identification of the desired target group.

The scheme rules should, as much as possible, exclude entities that would be able to access finance without the guarantee of the CGS. Credit guarantee schemes should normally target creditworthy SMEs whose risk and growth potential cannot be assessed by the bank and that lack assets that can be used by the bank as collateral. The growth potential often lies in high potential future cashflows or intangible collateral such as intellectual property.

Eligibility criteria may also include the type of need being financed, such as investments or working capital. Generally, CGSs are intended to support long-term investment, but in many cases their scope was extended to working capital during the crisis.

As well as targeting small firms generally, governments might, for example, choose to focus a CGS scheme on individual sectors or groups of sectors. A successful example is the Lithuania's Rural Credit Guarantee Fund which targeted farmers and relied on the expertise of banks that are active or specialised in loans to the agricultural sector (Box 2.1). Targeting firms outside the hydrocarbon sector could also support countries that are heavily reliant on extractive industries to help diversify their economies.

Box 2.1. Lithuania's Rural Credit Guarantee Fund (Garfondas) targets farmers

Lithuania's Rural Credit Guarantee Fund (Garfondas) was established in 2007 by the Lithuanian government and financially supported by the European Union. The initial capital was around EUR 6 million. The fund targets farmers and agricultural entities, rural SMEs and processors. In 2010, the majority of customers who borrowed with a guarantee were farmers engaged in crop production (52%) and animal husbandry (25%). More than half of the loans were used to purchase agricultural equipment. In order to understand the agribusiness sector the fund relies on a network of banks that are active or specialised in agriculture.

Source: Rural Credit Guarantee Fund (2010), Annual Report 2010, www.garfondas.lt/uploads/documents/METINES_ATASKAITOS/Fondas2010_EN.pdf, accessed 15 February 2012.

Funding needs to be mobilised with the involvement of private banks and market participants

A decision needs to be made regarding the relative roles of public and private sector representatives, the overall size of the planned programme and the maximum leverage allowed for the agreed amount of capital. Reaching financial sustainability should be one of the main goals of the scheme.

There are four major types of guarantee schemes based on the source of funding (Box 2.2): public, corporate, international and mutual guarantee schemes. Public guarantee schemes represent the majority of guarantee schemes worldwide. They have the advanatage of high credibility within the banking sector as the guarantees are paid directly from the state budget. However, the financial participation of the private sector and the corresponding influence in the decision-making process is also important especially in countries where political considerations may allow the schemes to extend credit to high-risk borrowers and were the risk management is not reliable (Green, 2003).

Box 2.2. Types of Credit Guarantee Schemes

Based on the ownership structure and the source of capitalisation, Green (2003) differentiates four major types of guarantee schemes:

- **Public guarantee schemes** are established by a government body thorugh public policy. They usually involve state subsidies, especially during the set-up stages. The scheme is typically managed by an independent organsiation or an administrative unit of the government. An advantage of this system is that in case fo default the guarantee is paid directly from the state budget, which gives such a scheme higher credibility within the banking sector.

- **Corporate guarantee schemes** are generally funded and operated by the private sector, e.g. banks and chambers of commerce. Corporate guarantee schemes have the advantage of being managed by experienced managers and benefit from direct involvement of the banking sector.

- **International schemes** are typically bilateral or multilateral initiatives between governments and NGOs. The international schemes often combine the guarantee fund with technical assistance to firms.

- **Mutual guarantee schemes** (mutual guarantee association/society/fund) are private and independent organisations formed and managed by borrowers with limited access to bank credit. Although they are largely funded by membership fees, in many instances they operate with the support of the government. Mutual guarantee schemes benefit from the active involvement, experience and expertise of their members.

Source : Green. A.,(2003); *Credit Guarantee Schemes for Small Enterprises: An Effective Instrument to Promote Private Sector-Led Growth?*, the United Nations Industrial Development Organization (UNIDO) Working Paper No. 10, August 2003

Financial institutions and the banking sector with experience in the SME segment should also be consulted on the initial size of the fund to ensure an adequate scope. The calculation of funding requirements will have to take into account the leverage effect of the scheme, which will be low in the initial stages of the fund and then improve as the scheme operates successfully. Initial planning should also involve discussions with commercial banks and market participants with existing expertise in target economic sectors, where appropriate.

Initially, governments might choose to start with a smaller programme allocating guarantees for very small loans, perhaps in one or two pilot schemes. The CGS can be scaled up at a future date if initial results prove promising.

Pricing should reflect to a certain extent the costs and risks of the guarantee

As regards fees, a balance has to be struck between sustainability and willingness of borrowers and lenders to participate in the scheme. Fees for guarantees need to cover at least the administrative costs of the CGS and could be risk-adjusted, so that riskier borrowers pay higher fees. Attempting to cover in addition the entire default risk is rather unrealistic, which means that schemes will often have to be subsidised. Pricing decisions also need to bear in mind that the objective is to provide better access to financing, and it needs to be ascertained that lower interest rates are not wiped out by the charges levied for guarantees, especially as charges levied on lenders are likely to be passed on to borrowers.

Fees can be levied based on loan amount and guarantee amount, with the latter prevailing. Typically fees are about 2% of guarantees.

Some countries adjust the fees based on the maturity of the loan (e.g. SEBRAE of Brasil) or based on the coverage (e.g. Fondo Nacional de Garantias of Colombia).

Risk management is necessary to reduce moral hazard

Risks should be shared with banks either by guaranteeing a share of the loan and/or by forcing the bank to undergo legal procedures to recover the loan before reimbursement. This would provide banks with an incentive to evaluate loan applications properly as they bear part of the lenders risk or legal costs in case of default. Prior experience shows that, in order to reduce moral hazard, CGS schemes should not aim to guarantee 100% of the loan covered, but instead should cover 50 to 70%. For example, a unique procedure for determining the coverage is applied by the Chillian Guarantee Fund for Small Enterprises, where the banks bid on the coverage of the loan (Box 2.3).

Box 2.3. The Auction System of the Chilean Government Guarantee Fund for Small Enterprises (FOGAPE)

FOGAPE is a government fund which provides guarantees for SMEs on a portfolio basis. The fund started its operation in 1998, and is administered by BancoEstado. Currently it has a capital of USD 80 millions, and a maximum leverage ratio of 10, i.e. it can insure up to USD 800 millions.

A main feature of FOGAPE is the auction system used to distribute guarantees and set coverage rates. In fact, in 2005 a similar system, modelled after the FOAGPE auction system, was adopted in Mexico. The bidding takes place four to six times per year. Only supervised financial institutions can participate. The credit evaluation of the borrowers is fully delegated to the financial institutions participating in the system; the fund neither screens nor approves the loan, nor has any direct relationship with the borrower. This delegation works as the banking sector is reasonably developed in Chile and some banks have a long experience lending to microfirms.

In every auction FOGAPE distributes resources for three types of credit guarantees: (i) 50 percent of total resources go to short-term loans; (ii) 30 percent go to long-term loans, exporters and emerging companies; and (iii) the remaining resources go toward other credit. Tenders are selected based on the coverage rates proposed by lending institutions – lower coverage rates are selected before higher coverage rates. Once the tenders have been accepted, FOGAPE establishes a contract with the winning financial institution fixing the coverage and commission rates, and outlining the contractual obligations of both parties in the case of default. Interestingly, the auction system has led to decreasing coverage rates – average coverage rates have fallen from 80% when initiated in 2000 to 65% in 2004.

Once the contract is concluded between FOGAPE and the lending institution, loans based on the guarantees must be distributed to borrowers within a two month time frame. If during that period, the guarantee is not used, FOGAPE calls for a new bid. In 2005, lending institutions typically used 85 percent of the resources available. In order to increase coverage, FOGAPE recently required that the contracting financial institution must use 90 percent of the guarantees awarded to them.

It is interesting to note that over time the average coverage rate determined during the auction has fallen. For example, the average coverage rate bid in the auction for long-term loans remained at about 80% until 2004, when BancoEstado began to bid below it. Since mid-2005 the rest of the banks followed BancoEstado and in 2006 the coverage rate fell to about 60%.

Another weakness in the FOGAPE system was recently fixed. In 2005 one financial institution obtained the majority of the resources distributed by FOGAPE. As a result, FOGAPE recently established a cap of 66 percent of total resources that one single contracting financial institution can receive.

Source: Benavente et al. (2006), FOGAPE: An Economic Analysis, University of Chilli; Llisterri. J., Rojas. A., Mañueco. P., López. V., Garcia. A., (2006); *Sistemas De Garantía De Crédito En América Latina*, Banco Interamericano de Desarrollo, Washington, DC 2006.

Similarly, in order to avoid the moral hazard of the borrower, it is advisable that he/she covers a share of the loan with personal assets. The requirements however should not be excessive as it would defeat the purpose of the guarantee.

The scheme's rules also need to clarify the relative responsibilities of the CGS and lenders in terms of initial credit risk assessment, and the ongoing monitoring and management of loans in order to avoid duplication of effort and costs. While risk assessment can improve with the involvement of both the CGS and the lender, the amount of applications processed will decrease due to more complicated procedures. This trade-off between risk management and amount of loans that can be provided should be taken into account when setting the rules of credit risk assessment.

Given the heterogeneity and variation in performance of SMEs, an accurate risk assessment requires specific knowledge of the SME sector and area of activity. Business associations or chambers of commerce could be involved to contribute with their sector-specific knowledge. In addition, CGSs should cover only the commercial risk of firms, while they cannot and should not take care of the systemic risk (e.g. bad weather and input-output cycle for agricultural firms).

The regulatory framework and governance of CGS should be clearly defined

A framework should be established for the regulation and supervision of the CGS. For instance, the CGS could be regulated as a financial institution or receive another status (*e.g.* non-profit organisation).[7] The supervision could be the responsibility of the Central Bank or another dedicated authority. In any case, accurate control, transparency and detailed reporting of production of guarantees and costs need to be addressed. This facilitates also the assessment and monitoring of the schemes operational results, its final impact and financial sustainability.

The CGS could be managed by a governing board involving government and participating financial institutions, preferably from those that have expertise in assessing SMEs. To avoid conflict of interests between the different groups, the mission of the guarantee scheme should be clearly defined (see first key success factor).

Measuring the impact of CGSs is crucial to their success

Measuring the true benefits of a CGS is crucial as it provides the final proof of the efficiency of the scheme. Financial additionality, which is the true extent to which the scheme has boosted SME lending, is arguably the most important criterion, but schemes can also be evaluated on the basis of their financial sustainability and their wider economic additionality, which are explained in this section. Quantifying the impact of CGS based on the three criteria remains challenging due to its entanglement with other factors, such as the overall positive macroeconomic environment, and the intra-portfolio substitution effects, *i.e.* providing guarantees to SMEs that would have received credit anyway.

Financial additionality can be measured as the extent to which a CGS has boosted lending to firms that would otherwise not have obtained the credit they required (*i.e.* were credit constrained), or was able to offer credit at a lower cost or over a longer maturity period than would have been the case otherwise. Levitsky (1997) estimates that if CGSs are properly designed and implemented, they can create, on average, 30 to 35% financial additionality. However, measurement of financial additionality remains a challenge, in particular where borrowers under the scheme were not credit constrained in the first place. Evaluation is still possible by comparing the scheme's eligibility criteria with the type of firms actually served, by examining the guarantees granted differentiated by firm size, and by calculations of loan defaults adjusted for firm size. Other effectiveness measures might include the leverage ratio of the scheme, *i.e.* the quantity of credit generated from a given amount of capital.

Financial sustainability measures the ability of the scheme to generate the funds to continue its operations without the need for further allocations from the national budget, and to manage costs. Revenues largely derive from the guarantee fees charged to lenders and/or borrowers, administrative fees levied on participants, and financial returns on reserve assets held to meet future guarantee obligations. Costs include the cost of funds, operational costs and losses from guarantees paid out to cover loans that have defaulted. Operational costs will be affected by administrative and management overheads, along with the degree to which the CGS is involved in risk assessment and loan follow-up operations (as opposed to leaving evaluation and administration of loans up to the lender). Costs and liabilities will also be affected by the availability of government counter-guarantees, third-party re-insurance facilities and the fund's guarantee volumes and default rates.

Econometric model-based analyses can provide some indication of the *economic additionality*, i.e. contribution of a CGS to faster growth and improvements in general economic welfare. This might include higher investment, exports, output and employment, as well as higher incomes. The burden on public financing of the scheme, both directly via budget allocations and indirectly through the provision of counter guarantees, then has to be set against these benefits. For example, Riding and Haines (2001) showed that job creation in the firms that benefitted from the Small Business Loans Association (SBLA) programme in Canada was 1.53 on average, compared to 0.16 in the firms that did not participate in the programme.

Chapter 3

Assessment of credit guarantee schemes in Central Asia

Currently CGSs operate in three countries in Central Asia: Afghanistan, Kazakhstan and the Kyrgyz Republic, but the interest in these tools has increased and a number of initiatives have also developed in other countries of the region. A CGS in Mongolia is currently under development. This chapter is organised in two parts. The first part is devoted to the assessment of guarantee schemes available in Central Asian countries and provides recommendations to improve their impact. The second part looks at countries that do not yet have CGSs in place and provides guidelines for their establishment.

Credit guarantee schemes operating in countries from Central Asia should be reviewed and revised periodically in the light of new experience

At present only three countries from the Central Asia region – Afghanistan, Kazakhstan and, more recently, the Kyrgyz Republic – have a CGS in place. Mongolia has also established a CGS, but it is not yet operational. The schemes adopted so far in Central Asia differ quite significantly in terms of their legal form, funding sources, scale of operations and systems of governance (Table 2.1). There are also significant differences in terms of capitalisation, pricing structure and levels of coverage.

Countries that do have a CGS in place should ensure regular evaluations of the schemes and adjust their design and procedures of their activity accordingly. Afghanistan's scheme has a longer operating record (since 2005) and has achieved good results. However, there are still areas in which the scheme could be made more effective. In Kazakhstan and the Kyrgyz Republic, the operational history of the CGSs is too short to draw any firm conclusions about their performance as yet, but there are a number of areas in which the schemes could be improved and extended.

Afghanistan

In Afghanistan there is no credit guarantee scheme supported by the state, but a donor-funded CGS successfully operates since 2005. The CGS was established with a capital of USD 9 million provided jointly by USAID and the German Ministry of Economic Cooperation and Development. It is currently operated by DEG, the private sector investment arm of Germany's KfW Development Bank.

The CGS aims to develop local financing capacity for the SME sector, both in terms of the availability of funds and the technical expertise of local borrowers and lenders. The main beneficiaries of the scheme are small businesses from rural areas who need loans of USD 3 000 to USD 1 million.

The design of the CGS in Afghanistan took into account lessons learned from earlier CGSs. It aims to reduce the risk of moral hazard by aligning the interests of both the bank and the guarantor through risk sharing, and to increase transparency and efficiency by screening individual loans rather than offering blanket guarantees for loan portfolios. Moral hazard is also reduced by the fact that the credit guarantees are not disclosed to the actual borrower. The scheme operates on a commercial basis without government involvement, reflecting the desire to limit the risk of political interference, which is a significant risk in many developing economies. In order to reduce risks related to the scheme's capital, the guarantee funds are held and invested overseas.

Table 2.1. Credit guarantee schemes in Central Asia

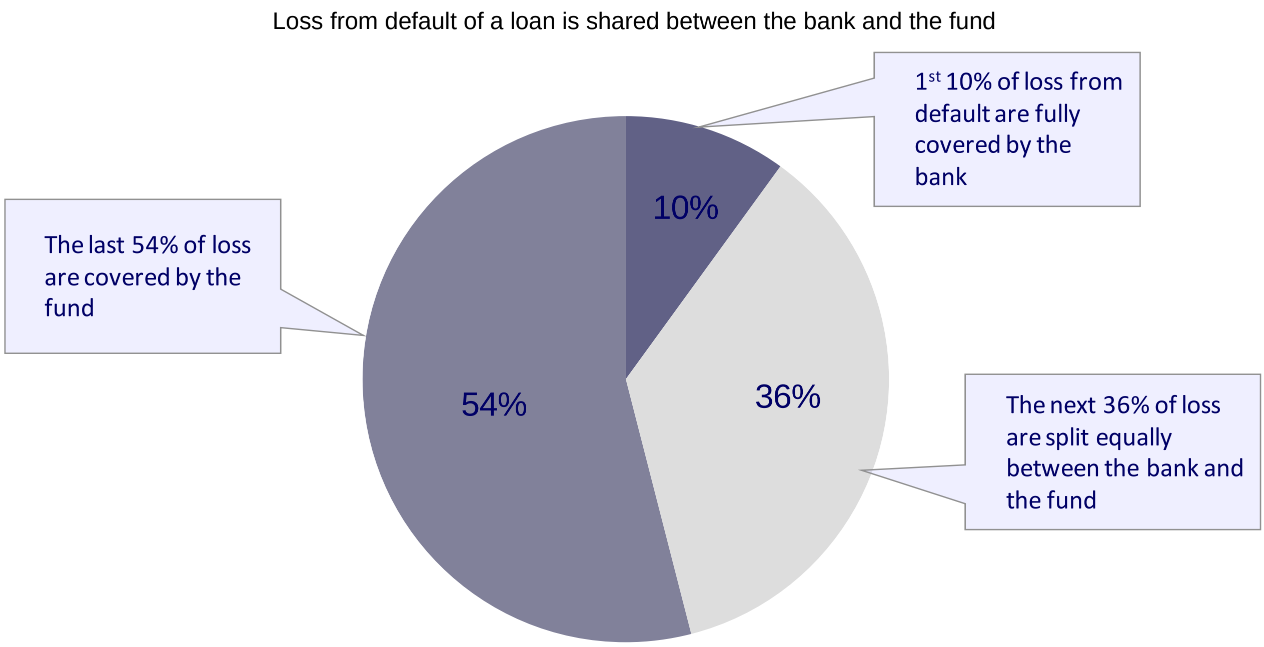
	Afghanistan	Kazakhstan	Kyrgyz Republic	Mongolia
	DEG guarantee scheme (2005)	**DAMU guarantee fund (2010)**	**Kara-Balta and Jalal-Abad guarantee funds (2011)**	**Credit Guarantee Fund (2012 – not yet operational)**
Mission	Provide credit guarantees for small businesses and develop the financial skills of the target group.	Provide credit guarantees to start-ups and small businesses	Provide credit guarantees for small businesses	Provide credit guarantees for small businesses

Targeting	Small businesses needing loans of USD 3 000 to USD 1 million. SMEs in rural areas.	Start-ups and other SMEs.	Focuses on very small local projects (due to limited capital).	SMEs needing loans up to MNT 100 million (approximately USD 71 700)
Funding	Initial co-funding by USAID and German Ministry for Economic Cooperation and Development. Initial capital of USD 9 million. Scheme is now self-sufficient.	Regional governments in the framework of Business Roadmap 2020. Government pays DAMU 20% of loan guarantee costs.	Transfers from local government totalling KGS 2 million (approximately USD 42 000) per year in 2011, 2012 and 2013.	Initial capital of MNT 1.3 billion (approximately USD 932 000) Public-private partnership with the participation of Government of Mongolia, seven banks, the Mongolian National Chamber of Commerce and the Mongolian Bankers Association
Pricing	Guarantees priced on basis of lenders' credit performance.	DAMU scheme offers guarantees of up to 70% on small loans, 50% for larger loans. Cost is 1% of guarantee amount.	Scheme charges a fee of 1.5% of loan amount to lenders. Interest rates set at market rates, but guarantees mean these are lower than for other loans.	na
Risk management	Guarantees cover 72% of loans, with the first 10% of any loss borne by the lender, plus half of the next 36% of loss. Applications for guarantees from partner banks are screened by DEG, which also provides technical training to staff of partner banks.	Credit assessments and lending decisions made jointly by DAMU and the lending bank. Guarantees are for up to 5 years.	Guarantees of up to 40% of loan amount and up to 10% of fund capital. Screening of applications is conducted by banks. Lenders also assist CGS staff with evaluation of creditworthiness.	na
Governance	Scheme entirely administered by DEG (subsidiary of Germany's KfW development bank) with no Afghan government involvement. Operates as a commercial bank.	The scheme is operated by the Entrepreneurship Development Fund (DAMU). The decision for providing a guarantee is taken by a Co-ordination Council which includes regional mayors, banks, associations and independent experts.	Established as an independent not-for-profit organisation with USAID technical assistance. A supervisory board sets the business plan and a credit evaluation committee assesses loan and guarantee applications.	Law on Credit Guarantees was adopted in February 2012.

Source: Self-assessment questionnaire "Access to Finance for SMEs in Central Asia" conducted by OECD among the governments of Central Asia countries.

As an incentive to local partner banks to improve and maintain higher standards in terms of credit evaluation, the scheme does not offer full coverage of loans extended under its guarantees. The first 10% of any loss incurred as a result of default is borne entirely by the lending bank. Losses of up to another 36% of the loan amount are split equally between the lending bank and the fund (18% each), while the remainder is fully covered by the guarantee fund. This means that the bank stands to lose up to 28% of its loan (while the fund would lose 72%), providing an incentive for partner banks to assess loan applications diligently (Figure 2.3). Moreover, the CGS varies the fees it charges banks for providing guarantees depending on the bank's credit performance.

Figure 2.3. Risk sharing in the DEG scheme in Afghanistan



Currently, the scheme is self-sufficient, and covers all its administrative costs from fees. Losses were incurred only in 2009 and 2010. In addition, the quality of the portfolio is good, with the ratio of non-performing loans as low as 2.1% according to DEG.

By the end of 2011, it had issued guarantees for a total of USD 69.6 million in loans. Going forward, DEG plans to increase its capital in order to expand its operations.[8]

The challenges of operating in a high-risk investment climate such as Afghanistan's include the problem of finding appropriate partner banks, particularly in view of the high turnover rates among local bank staff. High turnover reduces the effectiveness of efforts by the CGS to build up technical expertise at partner banks. The scheme currently has three local partner banks with other local institutions having expressed interest in the scheme. In recent years, it has expanded to cover 12 provinces (from six) and in 2011 57% of lending was outside Kabul.

In addition to providing guarantees, the fund aims to increase the capacity of local borrowers and lenders to deal with financial instruments themselves, through a programme of training in credit technology and technical assistance. The budget for local capacity-building efforts through the technical assistance programme amounted to USD 770 000 in 2011, an investment that comfortably exceeded the other operational costs of the CGS, which amounted to around USD 408 000 in the same year. The technical assistance programme includes training bank staff in credit technology, providing help with recruitment and selection, and helping to improve claim appraisal and process development.

Recommendations

- Leverage the experience of the already existing guarantee scheme by organising capacity building seminars with experts from DEG staff and share experience in how to address obstacles specific to Afghanistan such as underdeveloped financial sector and limited number of potential partner banks. Finding bank partners currently remains a challenge, particularly in view of the high turnover rates among local staff, which makes it difficult to invest in staff training.

- Consider contributing to the CGS to reduce the dependency of the country on donor funds. Involving government staff to work jointly with the DEG experts could be useful to create the capacity for a future guarantee scheme initiated by the government.

Kazakhstan

Borrowers in Kazakhstan face slightly smaller hurdles in providing collateral than those in other countries of the region, due to the existence of a unified cadastre system that registers all real estate, as well as lower collateral requirements. Even so, borrowers may still find themselves with insufficient collateral and banks are generally reluctant to lend to SMEs considering the associated risk and lower returns. Indeed, the banking sector in Kazakhstan suffers from a very high non-performing loan ratio of 26.3% out of the total gross loan in 2011 (WB/WDI), which deters banks from offering loans, especially to risky borrowers like SMEs.

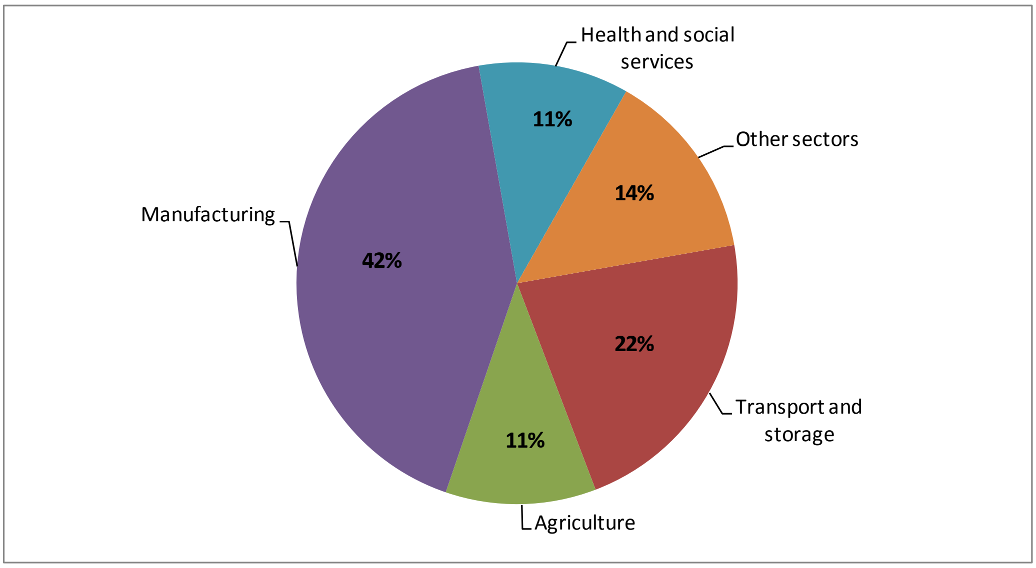
Kazakhstan's CGS is operated by the DAMU Entrepreneurship Development Fund (DAMU) and is part of the Business Roadmap 2020 programme to promote entrepreneurship and business growth.[9] The scheme was established in 2010 after the adoption of the roadmap. The scheme targets SMEs, including start-ups and established firms, operating in economic sectors defined as a priority within the framework of the Business Roadmap 2020 programme, such as manufacturing. The scheme also prioritises projects of modernisation and expansion of production, as well as purchase and modernisation of equipment. There is no information on the maximum capital allocated to the scheme.

DAMU provides guarantees to both start-ups and established firms. The scheme provides guarantees for a maximum of 50% for loans above KZT 20 million (around USD 135 000). These guarantees are normally provided to established firms for up to five years and DAMU charges 1% of the loan amount from the borrower for providing the guarantee. The scheme also sets a limit of 14% on the interest rate that banks can charge on guaranteed loans to limit the risk. The scheme provides guarantees for a maximum of 70% of loans up to a limit of KZT 20 million (around USD 135 000) for start-ups.

Since its establishment in 2010, the guarantee schemes within DAMU have approved 121 out of 167 applications. Among these, the scheme has provided 96 guarantees, in the amount of USD 36.9 million, covering total loans of USD 95.9 million. The fund offered 42% of guarantees to manufacturing companies with limited guarantees going to other sectors of the economy (Figure 2.4). There is no information of guarantees by firm size.

Figure 2.4. Guarantees provided by DAMU by sector in 2010-2012

Most guarantees were provided by DAMU to firms in the manufacturing sector



Source: DAMU, survey on Access to Finance for SMEs conducted by OECD in 2012.

The CGS has been criticised for delays in processing applications, although there have more recently been changes in the scheme aimed at speeding up the approval process. Currently, the final decision of providing a guarantee is made by a Regional Co-ordination Council, a body chaired by the regional mayors, with the participation of local executive bodies, banks, associations and experts. The final decision of providing a guarantee is made by the Regional Co-ordination Council, only after the bank approves lending to the firm, conditional on a guarantee being issued. The government is considering further changes to the system that would allow SMEs to apply for a guarantee first, and then consult the 23 banks participating in the scheme to find the best loan terms.

Recommendations

- After two years of operation, the scheme should conduct a performance evaluation based on the main success criteria for a guarantee scheme: leverage, sustainability, and coverage. This could be done by setting certain goals (*e.g.* number of guarantees provided or number of guarantees provided to SMEs) and evaluating the results of the scheme in relation to these goals. Financial additionality can also be assessed by looking at the expansion in the number of guarantees relative to net increase in SME lending. The evaluation of procedures and application process can be done by conducting satisfaction surveys among SMEs that received guarantees.

- The number of provided guarantees should be further increased and the scope be extended to other important sectors of the economy such as agriculture and ICT. In this respect, the Ministry of Agriculture's plan to establish a sector-specific CGSs scheme in the framework of the programme for the development of an agri-industrial complex in the Republic of Kazakhstan 2013-2020 aims to close the financing gap for agri-business SMEs (see Box 2.2). The expansion of the scheme would also entail building competences for servicing SMEs in these sectors, or by using the capabilities of existing sectoral associations or local institutions to conduct a more informed risk assessment.

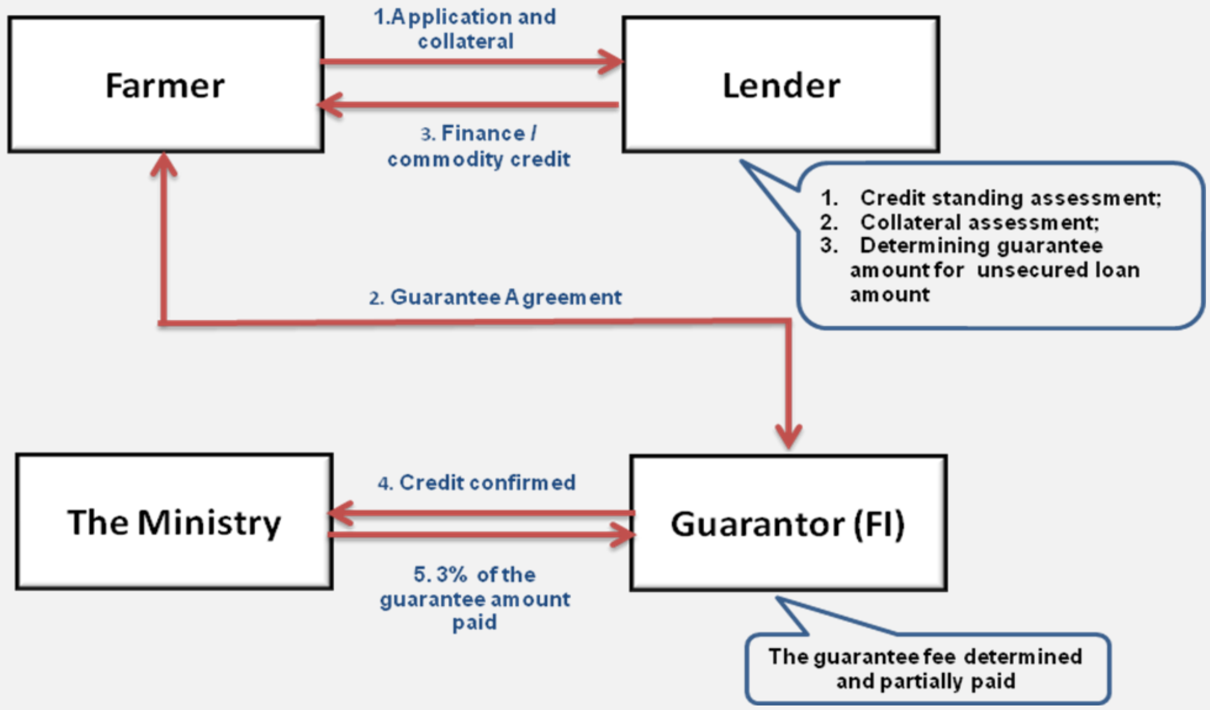
Box 3.1. Credit guarantee scheme under the programme for the development of an agri-industrial complex for 2013-2020, Kazakhstan

Following the new programme for the development of an agri-industrial complex in the Republic of Kazakhstan for 2013-2020, which is still being elaborated, a credit guarantee scheme for the agribusiness sector is planned to be established under the responsibility of the Ministry of Agriculture. It will involve KazAgro, the agricultural state-owned company, which, as of January 2012, together with its subsidiaries, holds 59.6% of all loans for agri-business in Kazakhstan.

Based on this scheme (Figure 2.5), SMEs are expected to apply for a loan from a bank, which assesses the borrower's credit standing and the value of collateral offered to support the loan application. The guarantor organisation will offer the guarantee to the SMEs and set a fee for offering a guarantee on the unsecured portion of the loan. The Ministry of Agriculture will subsidise the cost of the guarantee to the guarantor, paying up to 3% of the loan amount.

This scheme reduces the collateral requirements and the cost of guarantees for borrowers, reducing the reluctance of banks to lend to small agricultural enterprises. The scheme is designed to reduce the risk of moral hazard, as the state does not offer guarantees directly, but simply subsidises the cost of the guarantee to the guarantor organisations – KazAgro subsidiaries.

Figure 2.5. The design of the CGS to be established under the programme for the development of an agri-industrial complex 2013-2020



Source: Draft programme for the development of an agri-industrial complex in the Republic of Kazakhstan 2013-2020; Presentation by Mr. M. Tolibayev, Ministry of Agriculture of Kazakhstan, 18-19 September 2012, Istanbul, Turkey; OECD (2012b), Improving Access to Finance in Kazakhstan's Agribusiness Sector, Policy Handbook, OECD, Paris.

- Streamlining of the guarantee approval procedure which is currently cumbersome both for the bank and for the borrower should be a priority. This could be done by reducing the number of steps needed before the application is approved and the creation of a joint group of representatives of the bank and fund to assess the applications. The use of portfolio guarantees could be considered to allow the banks to make their own portfolio of borrowers with a certain risk level set by the fund, and thus avoids the assessment of every single application.

- The governance and risk management of the CGS could be strengthened by ensuring that public sector involvement in the decision-making process is minimal. The fact that the Co-ordination Council, chaired by the mayor, is currently involved in the decision-making process raises questions with regard to the credibility and political independence of the scheme. The decision-making should be made by the bank and the fund.

The Kyrgyz Republic

Small businesses in the Kyrgyz Republic face similar problems to those in the rest of Central Asia in securing access to credit: mainly insufficient collateral and high borrowing costs. To combat this, the USAID Local Development Program includes a scheme to establish loan guarantee funds in the regions of the Kyrgyz Republic. The programme was established in 2009, but its operations did not start before 2011 due to lack of specialised staff (USAID, 2012). Two pilot guarantee programmes were established in 2011 and are successfully operating in Kara-Balta and Jalal-Abad and another two are planned to be set up in the near future.

The Kyrgyz Republic does not have a legal framework for regulating credit guarantee schemes. Nevertheless, the law allows the local authorities to allocate resources to non-profit organisations to promote economic development of their territory.[10] The guarantee schemes are therefore set up as not-for-profit organisations supported by USAID, and are funded by transfers from local governments. In 2011, the schemes received KGS 2 million (approximately USD 42 000) from municipal budget in start-up funding, followed by another KGS 2 million in 2012. A final tranche of KGS 2 million will be added in 2013. The funds also receive revenues from deposit fees from banks for issued guarantees, commission fees and government bonds fees. Full sustainability of the guarantee fund has not been reached yet, but is expected after the third and last tranche from the local governments (municipalities) in 2013.

The CGS targets different sectors in the regions of operation, providing guarantees to agricultural and non-agricultural processing companies, as well as textile and tourism firms. It offers guarantees for up to 40% of loans extended to borrowers, leaving lenders with the remaining risk on 60% of the loan. Banks provide loans for 2-3 years, while guarantees are issued for up to one year, ensuring a high leverage of the guarantee funds. Commission charges for the guarantees are 1.5% of the loan amount, while interest charges to borrowers are set at market rates, but are lower than other, non-guaranteed credit products.

The evaluation of the creditworthiness of the SMEs and the decision on the type of credit is entirely made by the bank. After evaluation, the bank submits a request for a guarantee to the fund.

Since their establishment, the guarantee funds have had an important impact on the municipalities in which they operate. By 15 November 2012, the funds had offered 50 guarantees amounting to USD 106 400 on loans totalling USD 427 000 (Table 2.2). Although the operating history is short to make any firm conclusions, the average leverage ratio of 4 is reasonable given two years of activity of the funds. It is generally accepted that a guarantee scheme should reach at least a leverage ratio of 5 after 5 years of activity and that this ratio is much lower for developing countries (Levitsky, 1997).

The guarantees were provided mainly to SMEs in the trade sector (62% of the total number of guarantees), but also services, manufacturing and agriculture. Up to November 2012, all the loans provided within the framework of the CGS were repaid. The outreach of the programme will be increased with the creation of other regional schemes planned for the near future.

Table 2.2. Guarantees provided by local guarantee funds in Kyrgyz Republic

Fund	Number of guarantees	Amount of guarantees (in USD)	Amount of loans (in USD)	Leverage ratio
Kara-Balta	30	60 thousand	277 thousand	4.6
Jalal-Abad	20	46.5 thousand	150 thousand	3.2
Total	50	106.5 thousand	427 thousand	4

Source: USAID Local Development Program as of 15 November 2012, survey on Access to Finance for SMEs conducted by OECD in 2012.

A low level of capital limits the scope of the guarantee fund, but there are plans for further increase in capacity. The small available capital has limited the size of the projects that can be covered, with most guarantees having gone to very small projects, mainly in the agricultural sector. The CGS also sets limits on loan size, stipulating that guarantees cannot be more than the equivalent of 10% of the guarantee fund capital, *i.e.* approximately USD 4 200. Once the pilot projects are complete there are plans to seek donor and private sector funds to capitalise larger schemes.

Recommendations

- While it is relatively early to assess the success of the scheme, a procedure for monitoring and evaluating its success should be established based on the main success criteria for a guarantee scheme: financial additionality, leverage, sustainability, and coverage. This could be done by setting certain goals (e.g. number of guarantees provided or number of guarantees provided to SMEs) and evaluating the results of the scheme in relation to these goals. The evaluation of procedures and application process can be done by conducting satisfaction surveys among SMEs that received guarantees.

- Developing a legal framework for regulating loan guarantee activity should be a priority. Apart from regulating the activity of the bureau, national legislation on guarantees will also allow the expansion of guarantee funds at a national level, which will also bring a higher level of funds and allow the financing of small to medium-scale investment projects. The guarantee law(s) should cover all aspects of the guarantee activity, including provisioning, capitalisation and tax incentives.

- Expanding fund activity through larger geographical coverage through progressive involvement of local banks could help reach a larger number of firms outside the municipalities already covered and through larger sectoral coverage by increasing the share of guarantees provided to higher value-added sectors, including manufacturing and services.

Mongolia

Although bank lending to the private sector has grown rapidly in recent years, access to credit for SMEs remains a problem in Mongolia, particularly in rural areas. Interest rates are high, bank loans tend to be short term and collateral requirements are significant, particularly as there is no central registry of movable collateral (World Bank, 2012b). Access to finance remains an issue also due to high transaction costs incurred by banks in reaching SMEs in a country with the lowest population density in the world. The government is taking measures to improve access to credit in rural areas, mainly in the form of subsidised lending schemes, as well as direct lending schemes operated at the local government level without the involvement of other lenders.

Four previous independent guarantee funds were established with the support of the Dutch government and three donor organisations (GIZ, USAID and UNDP). The schemes allowed the release of MNT 710 million and MNT 2.2 billion worth of loans respectively, but were not institutionalised due to lack of a legal framework.

Having passed a law on credit guarantees in February 2012, Mongolia has established the Credit Guarantee Fund, which will continue the activity of GIZ Regional Economic Development guarantee scheme.[11] The fund is a public-private partnership established as a limited liability company with initial capital of MNT 1.3 billion (approximately USD 932 000). It involves the participation of seven banks and is supported by the Mongolian National Chamber of Commerce and the Mongolian Bankers

Association. Once operational, the fund will offer guarantees for loans by banks and non-banking financial institutions (which are predominantly microfinance organisations) to SMEs. The maximum loan size will be MNT 100 million (approximately USD 71 700).

The decisions on allocation of guarantees and risk management will be taken by a board of directors which consist of the representatives of the Ministry of Finance of Mongolia, banks and Mongolian National Chamber of Commerce and the Mongolian Bankers Association, as well as independent experts.

Recommendations

- Ensure wide economic outreach to SMEs in rural areas by co-operating with banks with a large geographical coverage or by setting up regional branches of the guarantee fund.
- Ensure a qualitative risk management and governance by minimising the political interference in the decision making process.

Countries that do not yet have a CGS in place should consider setting up a pilot project based on international good practices

Although the other three countries in Central Asia –Tajikistan, Turkmenistan and Uzbekistan – do not yet have CGSs in place, governments have taken some steps to improve access to finance for SMEs. In some cases these measures include lending programmes at subsidised interest rates, either directly or in combination with banks, and microfinance initiatives.

These countries could consider setting up credit guarantee schemes as pilot projects to further improve access to finance for SMEs. However, a CGS should be not be seen as a substitute for financial reform, and the establishment of a sound regulatory environment for financing remains a precondition for the efficient operation of a CGS.

The following sections provide a brief overview of the existing measures to support SME financing, as well as general guidelines on the establishment and design of CGSs for countries with no experience in developing such schemes. Box 2.3 provides an example of the work conducted by the OECD in collaboration with the government of Ukraine to set up a CGS in the agribusiness sector. This example could be of interest to policy makers from Central Asia, as it gives detailed guidelines on the set-up and features of a potential guarantee scheme based on international good practices and in-depth analysis of agricultural SMEs in Ukraine.

Box 3.2. Establishing a credit guarantee scheme in Ukraine

The work of the OECD Eurasia Competitiveness Programme in Ukraine focuses on the design and implementation of a credit guarantee scheme (CGS) to reduce and, more importantly, share risk. This policy option fits the Ukrainian country-specific context and, if properly managed, could offer recognised benefits and contribute to private sector participation.

The analysis showed that, to start the design of a CGS, Ukraine should: involve public and private players, target farms with 100 to 2 000 ha of land, allocate limited funding to key priority regions and carefully monitor risks and impact. Based on the analysis of Ukraine's baseline situation and the good practices observed in OECD countries, Ukraine can start the design of a CGS for credit-constrained SMEs by taking the following steps:

- Design eligibility criteria to target credit-constrained SMEs: a segment of agribusiness SMEs with between 100 and 2 000 ha of land. The average yearly financial requirements of these players range from USD 37 000 to125 000.

	MICRO	SMALL		MEDIUM
	BELOW 100 ha	*100- 1 000 ha*	*1 000 – 2 000 ha*	*2 000 – 10 000 ha*
NUMBER OF FIRMS	33 500	10 000	2 800	2 900
AVERAGE FINANCIAL REQUIREMENT PER YEAR UAH	18 k	300-700 k	800k – 1 m	2 m
% CREDIT-CONSTRAINED FIRMS	99%	90%	80%	70%
PERCENTAGE OF LOANS COVERED BY BANKS	Not applicable	Not applicable	Not applicable	30%

- Prioritise limited funding to key regions: given the existing constraints on the state budget, the initial focus of the CGS could be key regions with high agricultural production and low access to finance such as Cherkasy, Vinnytsia, Poltava and Kharkiv (in order of priority). Currently these regions receive both low support from public programmes and low-level loans from commercial banks.

- Allocate small funding and then scale-up once the scheme has shown positive performance and operate through pilot projects. An initial proposal might be to start with a small CGS within the range of a few hundred million UAH. This would allow focusing on one or two pilot regions.

- A credit-risk rating system could be developed and linked to a pricing model. An SME scorecard could be developed to cover both financial and non-financial criteria.

Source: OECD (2012a), Implementing Credit Guarantee Schemes in Ukraine: The Case of Agribusiness, OECD, Paris.

Tajikistan

Tajikistan faces similar problems as other economies from Central Asia in terms of access to finance for SMEs, having a relatively small financial sector in relation to GDP. Microfinance lending has risen rapidly in recent years, funded partly by international donors such as the EBRD, EU and IFC. But lending to small businesses continues to be hampered by the lack of transferable land-use rights, which precludes the use of agricultural land as collateral, despite recent moves to strengthen land ownership rights. The financial sector continues to be undermined by state-direct lending to priority sectors (*e.g.* cotton production). Interest rates are high (around 17% on local currency loans), as are collateral requirements, which make access to finance for SMEs difficult. As a result, bank lending accounts for only around 15% of GDP.

State-directed lending has also contributed to a high rate of non-performing loans (around 15% in 2011), although the government has pledged to discontinue the use of directed lending. Government policies to strengthen access to finance for SMEs have been limited, and have mainly revolved around measures to stimulate business activity generally, rather than focusing on SMEs. Most public investment is directed towards large, state-owned firms and infrastructure projects.

The government is currently considering the establishment of a CGS based on the experience of the guarantee scheme in Afghanistan.

Recommendations

- Improve the regulatory framework to facilitate the use of land as collateral, which could significantly improve access to finance for farmers and agricultural households.

- Set the mission and the target group of the new scheme and ensure qualitative risk management for the new initiative.

Turkmenistan

Government efforts to boost lending to the private sector in Turkmenistan include a scheme of state-directed lending at subsidised interest rates. Introduced in 2009, the scheme involves the central bank providing funds to lending banks at a cost of 3%. The banks then add a 2% margin and lend the funds on to businesses at a heavily discounted interest rate of 5%. However, the banks still have to vet loan applications and can demand high levels of collateral, which limits access to finance in the absence of clear property rights.

SME support in Turkmenistan is limited to microfinance schemes funded and run by international organisations such as the Asian Development Bank (ADB) and the EBRD. The country's main banks are state-owned and most lending is directed towards priority sectors, often dominated by state-owned firms. The banking market is concentrated, with the five largest (state-owned) banks accounting for 95% of activity (EBRD, 2010). The central bank also intervenes in credit markets by recommending maximum interest rates. The banking sector is also very small in relation to the overall economy, with bank lending amounting to just 2.5% of GDP in 2011 (EBRD, 2011a).

Recommendations

- Set a clear regulatory framework for property rights in Turkmenistan to ensure the use of collateral in lending.
- Consider the establishment of a credit guarantee scheme based on international good practice with public support and minimal public sector interference in the guarantee selection and risk management.

Uzbekistan

According to the 2008 Business Environment and Enterprise Performance Survey (BEEPS) conducted by the EBRD/World Bank, main obstacles to running a business in Uzbekistan include tax rates and access to finance. Only 10.5% of firms have a line of credit or loans from a financial institution, much lower than the regional average in Central Asia of 43.7% (BEEPS 2008-2009). According to the IMF's Financial Access Survey, bank lending was the equivalent of around 25.3% of GDP in 2011, which is lower than in some economies from the region (Mongolia, 64.8%; Kazakhstan, 47.8%) but higher than in others (Afghanistan, 5.3%; Kyrgyz Republic, 14.7%; Tajikistan, 14.9%). Access to formal bank loans is also restricted by the fact that the state grants farmers only a time-limited right to use land, not full property rights. The lack of clear and tradable land rights limits the availability of collateral for loans.

In order to overcome some of these problems, the government offers loans to SMEs in a range of economic sectors at heavily subsidised interest rates. Funds provided by the government and the central bank are channelled through the commercial banks through a range of policy lending programmes. For example, loans for qualifying agricultural enterprises are offered at 3%, which is far below the market rates. Subsidised mortgage loans are charged at 5%, and interest rates on lending under other schemes are calculated as a percentage (typically 16% to 50%) of the central bank refinance rate (12% at the end of October 2012). These interventions heavily distort the financial market and limit the availability of funds for small firms and firms that are not in the sectors prioritised by the government.

Recommendations

- A liberalisation of the financial market should be the first step towards a more efficient allocation of credit. Strengthening the regulatory framework for property right by providing full land property rights to farmers can further facilitate the use of collateral by small businesses.

- The government could also consider the implementation of a CGS, if minimal public sector interference in the governance of the scheme can be ensured.

Conclusion

Currently only three Central Asian countries – *Afghanistan*, *Kazakhstan*, and, more recently, the *Kyrgyz Republic* – have a CGS in place; in *Mongolia*, a CGS is being established but not yet operational. The schemes in Afghanistan and the Kyrgyz Republic were established with the help of foreign donors and are operated as private, not-for-profit institutions. The credit guarantee scheme in Kazakhstan was established as a government initiative, while in Mongolia as a public-private partnership. *Tajikistan*, *Turkmenistan* and *Uzbekistan* do not yet have a credit guarantee scheme in place, but are considering the establishment of a scheme in the future.

Afghanistan, *Kazakhstan*, *Kyrgyz Republic,* and *Mongolia,* the four countries in Central Asia with a credit guarantee scheme in place or under development, should ensure that the schemes are regularly reviewed and revised in the light of new experience and international good practice. In addition, based on the specific situation of each country, policy makers could already consider several adjustments of the CGSs to the local needs. Afghanistan could leverage the extensive experience of the DEG-operated CGS for a potential future project in this area with the participation of the public sector. In Kazakhstan and the Kyrgyz Republic the operational histories of the CGSs are too short to draw any firm conclusions, but their performance could be further improved by expanding their geographic and sectoral coverage. Kazakhstan should also focus on streamlining and simplifying the guarantee approval procedure. In Mongolia the CGS is not yet operational, but, for the future activity, it could pay special attention to the outreach of the scheme given that the country is one of the least densely populated in the world.

When setting up a CGS, policy makers in *Tajikistan*, *Turkmenistan* and *Uzbekistan* should consider first strengthening the regulatory framework for property rights and liberalising the financial market. Weak property rights remain a major obstacle to the development of the financial system and CGS, limiting the efficient use of collateral in financial transactions, while significant government interventions in the form of subsidised interest rates and direct lending distorts competition and credit allocation. As a second step after taking into account these initial recommendations, Tajikistan, Turkmenistan and Uzbekistan could consider setting up CGSs to further facilitate access to finance for SMEs based on international good practice and previous regional experience.

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Endnotes

1 The data on share in employment are calculated as employment in small business divided by total employed people; the share in number is based on working enterprises on 1 August 2011 (which includes firms which are new and are not yet active, firms that are active and firms that are temporarily inactive).

2 The figures do not include farms.

3 The data were provided by the Afghanistan Central Bank in the survey conducted by OECD on Access to Finance for SMEs in 2012.

4 State Committee for Statistics, Decree of the President of the Republic of Uzbekistan from 18.07.2012 on Further Measures for Cardinal Improvement of Business Environment and More Freedom for Entrepreneurship; available at http://www.stat.uz/basis/16/4756/?sphrase_id=43670

5 http://centralasiaonline.com/en_GB/articles/caii/features/2009/01/20/feature-03

6 The categories of small and medium-size enterprises in the EBRD BEEPS survey are defined as follows: small enterprises are firms with 5-19 employees, medium-size enterprises are firms with 20-99 employees, large enterprises are firms with 100+ employees.

7 The benefits of a guarantee schemes acquiring a financial institution status are not clear. On the one hand, it may give the guarantee scheme more credibility within the banking sector. On the other hand it can have implications on the costs of staff and resources of both the scheme and the public sector, outweighing the benefits of the scheme.

8 Working Group on Access to Finance for SMEs on 18-19 September 2012, Istanbul, Turkey

9 http://www.damu.kz/8303

10 Provisions of the Law of the Kyrgyz Republic on “Financial and Economical Basis of Local Governments” endows municipal authorities with a right to establish not-for-profit organisations, including Public Funds undertaking the guaranteeing activity, to promote economic development of their territory (http://ldp.kg/wp-content/uploads/2012/07/Guarantee-Fund-capitalization.pdf)

11 http://mongolianeconomy.mn/en/p/1813