

REVIEW OF GUARANTEE SCHEMES IN TANZANIA



ABOUT FSDT

The Financial Sector Deepening Trust (FSDT) was established in 2004 to improve the capacity and sustainability of the financial sector to meet the needs of MSMEs and poor men and women.

Our mission is to generate sustainable improvements in the livelihoods of poor households through reduced vulnerability to shocks, increased incomes and employment achieved through providing greater access to financial services for more men, women and enterprises.

Our vision is to achieve improved capacity and sustainability of the financial sector to meet the needs of MSMEs and poor men and women and to contribute to economic growth.

For more information on the FSDT, please see our website on www.fsd.t.or.tz

ACRONYMS

AECID	Agencia Española de Cooperación Internacional Para el Desarrollo (Spanish Development Agency for International Cooperation)
AFD	The Agence Française de Développement (French Development Agency)
AfDB	African Development Bank
AGF	African Guarantee Fund
AGRA	Alliance for a Green Revolution in Africa
ARIZ	l'Accompagnement du Risque de financement de l'Investissement prive en Zone d'intervention de l'AFD
BoT	Bank of Tanzania
CGS	Credit Guarantee Scheme
CNFA	Citizens Network for Foreign Affairs
CRB	Credit Reference Bureau
CRDB	Bank previously known as Community Rural Development Bank
DANIDA	Danish International Development Agency
ECGS	Export Credit Guarantee Scheme
FAO	Food and Agriculture Organization of the United Nations
FBME	Bank previously known as Federal Bank of the Middle East now headquartered in Tanzania
FI	Financial Institution
FSDT	Financial Sector Deepening Trust
GoT	Government of Tanzania
IFAD	International Fund for Agricultural Development
Kshs.	Kenya Shillings
MFI	Micro Finance Institution
NMB	National Microfinance Bank
OFID	OPEC Fund for International Development
OPEC	Organization of the Petroleum Exporting Countries
PFI	Participating Financial Institution
SACCO	Savings and Credit Co-operative
SBA	Strategic Business Advisors
SIDO	Small Industries Development Organization
Tsh	Tanzanian Shillings
US\$	United States Dollar
USAID-	
DCA	United States Agency for International Development – Development Credit Authority
WFP	World Food Programme

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Executive Summary

BACKGROUND

African countries are faced with the challenge of building competitive economies while also working to reduce poverty and food insecurity among their populations. For many of these countries, Tanzania included, the experience has been that while the economy has begun to grow consistently, the benefits do not trickle down to most of the population. To address this problem, governments and other stakeholders have adopted various policies and tools aimed at stimulating economic activity.

One such tool is the guarantee scheme (GS), designed to stimulate economic activity by addressing a market failure in the economy. This comes about when there is demand for a specific product or service by a segment of the population that goes unmet by suppliers, due to a perception of increased risk in providing the goods or service. A guarantee scheme helps intervene in such cases by taking on some or all of the perceived risk, thereby enabling the supplier to provide the product or service in question. An example is a performance guarantee scheme in which one party in a contract may require a third party guarantee that the counter-party will perform as required in the contract. Other examples include investment and credit guarantee schemes. This report details the findings of a review. The Financial Sector Deepening Trust (FSDT) commissioned Strategic Business Advisors (SBA) to study the guarantee schemes that have been and/or continue to be operational in Tanzania. The objective is to document their experiences and lessons learnt. In addition, the review also looks at the experiences of guarantee schemes outside Tanzania in order to absorb any other lessons and best practices that would be of value to current and future schemes in Tanzania. The focus of the review

is limited to guarantee schemes that target MSMEs and the agriculture sector.

MSMEs and Agriculture and the Tanzanian Economy

Tanzania is the largest country in East Africa, with a total area of 956,000 km², making it the 31st largest country in the world. The 2012 national census found that Tanzania had a total population of 44.9 million people, with 1.3 million of those living on the islands of Zanzibar. The World Bank estimates that Tanzania had a 2012 GDP of US\$ 28.25 billion, with agriculture and manufacturing industry accounting for 27% and 24% of GDP respectively.

According to a 2010 MSME National baseline survey sponsored by the Ministry of Industry and Trade and FSDT, there are about 3 million micro and small enterprises in Tanzania, employing over 5 million people. The same report found that 66.4% of all small businesses were completely excluded from access to financial services while only 10.6% had access to formal financial service providers such as banks. In a survey of 136 small firms in Tanzania, Satta (2003) found that 63% of them consider that difficulty in accessing

finance from financial institutions is the major constraint to their development.

Agriculture is an important sector for the Tanzania's economy. Over 75% of the working population relies mostly on this sector.

Agriculture contributes a sizeable proportion of the GDP (about 27%), a major source of foreign exchange earnings (about 30%) and food security. However, besides its importance to the economy and the nation's livelihood, the sector continues to face substantial challenges to its growth. One of these challenges is lack of finance.

There are over fifty national and regional banks as well as other licensed financial institutions (FIs) in Tanzania, the majority of which focus mostly or completely on corporate lending. These FIs cite the fact that the small loans requested by MSMEs do not justify the high transactional costs incurred in appraising the same loans. They also view agricultural lending as risky due to uncontrollable factors such as weather and volatile market conditions. In addition, most of these banks have high collateral requirements (up to 125% of loan value) which MSMEs find difficult or impossible to find. When all these factors are combined, very little credit finds its way to MSMEs or the agriculture sector.

Given the prominence of agriculture and small scale industry in the Tanzanian economy, it is necessary to find ways to increase credit facilities to support them. This will have a positive effect on both the economy as a whole, and the livelihoods of millions of Tanzanians working in these sectors. Credit guarantee schemes are one solution to this problem. They have made, and continue to make a significant contribution to the expansion of credit in Tanzania.

Methodology

Over a three week period, SBA conducted a series of face to face interviews with various banks and guarantors of the schemes operating in Tanzania. These were backed up with telephone interviews in cases where the individuals concerned could not be reached directly. For each scheme, SBA talked to at least one guarantor (in cases where there were multiple guarantors acting in partnership) and also at least one participating bank. In some instances it was necessary to rely on other past reports on these schemes.

Other stakeholders, including government officials and the ultimate beneficiaries of some of the guarantee schemes (i.e. SMEs and farmer groups who benefited from guaranteed loans), were also interviewed.

SBA conducted a desk review of numerous guarantee schemes across the globe and documented those that offered unique and valuable lessons that could be implemented by FSDT and other stakeholders in Tanzania.

Findings

The results of this review show that the credit guarantee scheme (CGS) is the dominant type of guarantee scheme in Tanzania. Demand for credit by micro, small and medium sized enterprises (MSMEs), and other sectors of the economy such as agriculture, has been overlooked by financial institutions, due to perceptions of high risk and/or low profitability of involvement in these sectors. The CGS takes on some of the risk involved in lending by guaranteeing compensation to financial institutions in the event of a loan default. This risk sharing encourages financial institutions to open the flow of credit to these previously ignored sectors. They are then able to put the credit to productive use, and so increase economic activity. SBA also found other guarantee products that have been recently introduced, including equity guarantees and leasing guarantees.

There are 15 credit guarantee schemes that have been, or continue to be operational in Tanzania. Of these, three have expired or been suspended:

- i)** SME Credit Guarantee Scheme funded by the Government of Tanzania. This was suspended in 2008 though according to the Bank of Tanzania, is set to make a comeback soon.
- ii)** Agribusiness and SME finance in Zanzibar funded by FSDT and operated by FBME bank. It operated for three years from 2007 to 2010 and was not renewed.
- iii)** Agro-dealer Guarantee Scheme by AGRA and FSDT in partnership with NMB bank. This expired in 2011 after a three year term with significant achievements, but was not renewed.

Another eight GSs with a combined capital in excess of US\$100 million have been in operation for at least one year. These include:

- iv)** ARIZ funded by AFD
- v)** PASS funded by DANIDA
- vi)** SME and Microfinance credit guarantee scheme funded by DANIDA
- vii)** CRDB Bank guarantee funded by AfDB and USAID
- viii)** Agricultural Credit Guarantee (ACG) funded by AGRA, OFID and Kilimo Trust
- ix)** Export Credit Guarantee Scheme (ECGS) funded by the Government of Tanzania
- x)** Sustainable Agriculture Fund (SAGF) funded by Rabobank
- xi)** African Guarantee Fund funded by AfDB and the Governments of Spain and Denmark.
- xii)** Four of these schemes, PASS, SAGE, ACG and USAID's scheme at CRDB are exclusively focused on agriculture, while only the DANIDA SME and Microfinance scheme exclusively covers SMEs. The other three, cover both agriculture and SMEs.

- xiii)** Finally, there were four other schemes, two of which have been operational for a year or less, and whose implementation details or performance could therefore not be verified. The other two were tangential to our focus on SMEs and agriculture:
- xiv)** xii.USAID-DCA guarantee scheme at National Bank of Commerce activated in 2013
- xv)** Women Access to Finance by DANIDA at CRDB
- xvi)** USAID/Promotion of Rural Initiative Development Enterprise (PRIDE) Corporate Bond Guarantee, which is more of a corporate guarantee scheme
- xvii)** African Trade Insurance, which mainly covers large private and public sector projects
- xviii)** In general, the active CGSs offer a coverage ratio of between 50% and 75%, although this can rise up to 80% for projects that promote women. Other than ECGS and SAGF which only cover the loan principal, the other schemes cover both the principal and some or all of the interest. Most of the schemes, accept claims within 60 days of the default event and they usually pay 50% of the claim, with the balance payable after all the loan recovery process is complete. The exceptions are SAGF and ACG, which only accept claims after the whole loan recovery process. Finally, other than ARIZ which starts as a retail scheme, all the others are portfolio schemes. This means that participating financial institutions are authorized to guarantee batches of loans within set parameters instead of submitting each individual guarantee request for approval by the guarantor.
- xix)** Beyond Tanzania, nine other guarantee schemes were reviewed and documented. These were spread out across the globe and chosen for the valuable lessons they had to offer. Two are in the Americas, two in Europe, three in Asia and two in Africa.

xx) This review documented twenty four guarantee schemes in total. The lessons that were extracted from them should help in the design and implementation of future credit guarantee schemes.

Lessons learnt

- 1) The efficient processing and payment of claims submitted by Participating Financial Institutions (PFIs) is possibly the greatest determinant of a scheme's impact and sustainability. PFIs tend to get increasingly frustrated by the slow processing of claims and become reluctant to process new loans under the scheme. Changing of claim submission rules after claims have already been submitted destroys the credibility of the scheme.
- 2) All parties involved should bear some risk. It is therefore critical that both the PFI and borrower maintain an active interest as this ensures each party is aware of and takes measures to prevent potential losses in the event of a default. The borrower should give some form of collateral even if it is not the kind traditionally accepted by banks (e.g. signing a lien on his livestock in exchange for a loan for purchasing farm inputs). Likewise, the guarantor should ensure that the PFI carries a portion of the loan not covered by guarantees or collateral.
- 3) Technical knowledge is essential. It is not sufficient for guarantors to put up guarantee capital and trust that PFIs will take care of the rest of the details. This is especially true in Tanzania and other developing countries where FIs have yet to develop the sophisticated technical capacity necessary for agricultural and SME financing. CGSs should be proficient in credit analysis, risk management, portfolio and treasury management in order to supplement and help improve the capacity of the PFIs.
- 4) Agricultural credit guarantee schemes can expect higher loss rates than SME schemes because there are more variables in agricultural finance that cannot be controlled. This is especially true in East Africa where most agriculture is greatly influenced by the weather, farming is on a small scale and prices of produce are volatile and beyond local control. Agriculture also tends to be a politically charged issue. Government policies such as the banning of imports or exports of a particular product can also result in losses which will hurt a guarantor.
- 5) Size matters. Large GSs such as those funded by USAID-DCA and DANIDA are usually favoured by FIs because they allow them to expand their operations significantly. On the other hand, smaller schemes tend to be seen as not worth the effort, especially if not from the same donors who fund the larger GSs. Small schemes may also be doomed from the outset because they will never achieve the economies of scale necessary to be self-sustaining. In general, the Tanzanian FIs interviewed in this review considered schemes with less than USD\$1 million to be small. It is feasible that a smaller FI might be willing to work with a small CGS. However, it also follows that the smaller FIs might be more challenged in terms of the technical capacity to achieve the CGS objectives.
- 6) Credit Reference Bureaux: the potential long term benefits of CGSs will be completely lost if all the new borrowers generated are unable to build a credit history that will help them to approach any FI and get a loan on the basis of the good credit history. CRBs also help to reduce the information asymmetry which contributes to an increased perception of risk and subsequent high interest rates.
- 7) Publicity: it is generally a good idea to avoid publicity of the guarantee scheme, especially if it cannot be controlled. This is a problem

especially for government funded schemes where politicians are likely to encourage their constituents to go for 'free loans'. However, publicity can be used to create awareness of the scheme as long as it is made clear that there is no free money and all lending procedures are to be followed.

- 8) Grouping of farmers (as cooperatives, associations or out-grower groups) helps to reduce transaction costs for PFIs. Another benefit especially applicable to Tanzania is that financial institutions do not have to contract with each individual farmer who may have difficulties understanding the details. Instead, the more knowledgeable group representatives can effectively interface with the financial institutions. Group dynamics can also be leveraged whereby peer pressure by group members helps to keep defaults low. Ultimately, groups enhance bargaining power for farmers while helping to realize economies of scale.
- 9) Credit guarantees do not make bad projects more bankable, nor do they make bad financial institutions better. It is therefore critical that the only loans guaranteed are for projects that are otherwise viable, except that they are not considered 'bankable'. Similarly, guarantors should not simply hand over funds to arbitrarily selected banks and expect them to achieve the set objectives. There should be good due diligence not just on borrowers but also on banks.
- 10) The impact of guarantee schemes is significantly constrained by macro variables that may be out of the scheme's control. Some of these variables include the effectiveness of the country's judicial system, the financial regulatory system and the entrepreneurial capacity of the population targeted by the scheme.

Best Practices

- 1) The following are the best practices documented from the experiences of various credit guarantee schemes around the world. Many have been in existence for decades and have developed these practices following several challenges and failures that could potentially arise in Tanzania also:
- 2) The German Ministry for Economic Cooperation and Development advocates a four step process for planning and creating a CGS. First, consultations should be held with all stakeholders and market research should be carried out to define the status of the target market. Second, the information collected from the first stage should be used to create an optimal CGS design. Third, a pilot model is implemented to test the design and adjustments are made. Finally, the CGS is registered and rolled out.
- 3) The CGS should be designed with a commercial orientation as this enhances its sustainability. To this end, the scheme should be governed as an independent entity rather than as a project within a larger funding entity such as a government or donor organization. The scheme should also work to finance its own operations by charging fees commensurate with the cost of the services provided (i.e. no subsidization). Finally, the scheme should be responsive to the market, providing guarantee products that are actually demanded in the market and being aware of changes in the market place.
- 4) Selecting the right PFIs is critical to the success of the scheme. Some of the criteria used to select PFIs include: experience in the target market, e.g. agricultural finance, geographical coverage, financial position, effectiveness of the PFI's credit processes, political exposure and compliance with anti-money laundering laws.

- 5) The guarantee framework agreement between the guarantor and PFIs should be negotiated in good faith and the details documented as comprehensively as possible. Sensitive matters such as the nature of default events, the claim submission and payment processes, eligible loans etc. should be clarified as much as possible. These are the areas that can damage the scheme's credibility if the agreement is not followed.
- 6) Claims should be processed efficiently and in a manner that is sustainable for both the scheme and the PFI. Currently, the most favoured practice is to pay a portion of the claim within 60 days of the default event, and then pay any balance after all recovery measures have been taken by the PFI. Rather than slow down the claims process so as to discourage the submission of claims, the CGS can achieve the same objective by charging higher fees to the PFIs that submit too many claims.
- 7) There should be an on-going collaborative relationship with PFIs aimed at reducing risk and bringing additional borrowers into the credit system. The CGS should disseminate aggregate information from all its PFIs providing information on the risk levels in the market, new credit assessment procedures and models.
- 8) CGSs focused on agriculture can manage the risks associated with agricultural finance by investing in technical agricultural knowledge and adopting a value chain approach that covers producers, processors and sellers. Other helpful practices include diversifying the range of crops and livestock covered and encouraging borrowers to use warehouses to store produce.

Conclusion

CGSs all over the world have been used to great effect to get credit flowing to sectors previously locked out of the credit system and in some cases, to rejuvenate economies in crisis. Financial institutions have embraced credit guarantee schemes as effective and convenient risk sharing mechanisms. At the same time, borrowers have seen their businesses expand through access to credit and their livelihoods have improved. As with all tools, CGSs have their limitations and can even pose dangers to economies and financial institutions if not implemented correctly. This report highlights lessons learnt and best practices from around the world. If adopted, they can help improve individual incomes in Tanzania and help the country achieve its poverty reduction goals.

Recommendations

As a result of this review, the following recommendations can be made to the various stakeholders in Tanzanian guarantee schemes:

- 1) There is need for harmonization of the activities of the various schemes in Tanzania to maximize their impact. To this end, all stakeholders including borrower groups, guarantors, financial institutions and the government should come together to form a supervisory and coordinating body. This will act as a registry for Tanzanian guarantee schemes, thereby facilitating greater awareness of each CGS's objectives and activities. It will also allow more coordination and less undermining of each other's efforts. These stakeholders should be fully represented in the governing organs of such an entity. This body would have supervisory powers that enable it to verify the solvency of guarantors, limit market distorting activities and resolve claim disputes between guarantors and PFIs.

- 2) The government can also support CGSs and the financial sector in general by making the judicial system more efficient. This may mean more commercial courts to reduce the time it takes to resolve commercial disputes, or the establishment of alternative dispute resolution mechanisms. The government should also make it easier for individuals and corporations to own land and use it as collateral in order to access the necessary finance needed to develop the land. Finally, the government also needs to address the issue of identification. As long as there is no way of identifying each unique borrower and attaching a credit history to them that can be accessed by all FIs, the cost of credit will continue to be high as FIs experience high default rates on loans to borrowers with a record of defaults.
- 3) The BoT and the newly registered credit reference bureaux should work together to ensure faster integration of credit reference bureaux into the financial sector. This will create lasting financial sector deepening by ensuring that new borrowers are permanently brought into the credit system through credit histories accessible by all financial institutions. To achieve this, the requirement that all financial institutions submit credit data needs to be enforced. In addition, the infrastructure that will allow them to access the comprehensive credit databases, as well as the training in the use of new credit processes that take advantage of this data, should be provided.
- 4) The BoT should expedite the review of applications for first class bank status recognition so as to allow the affected guarantors to realize the fullest impact possible for their schemes.
- 5) Guarantors and financial institutions should work together to ensure that the CGSs are actually bringing new borrowers into the credit system. Guaranteed loans should only go to good borrowers who would ordinarily not qualify for bank loans due to collateral requirements or lack of a credit history. Added value can be achieved if the guarantor takes time to audit a sample of the borrowers being covered to ensure that were indeed not bankable.
- 6) Guarantors in collaboration with participating financial institutions should conduct regular monitoring and evaluation assessments, to determine if scheme objectives and target populations are being reached effectively.
- 7) Financial Institutions should embrace a new perspective in evaluating and appraising credit applications from small borrowers and MSMEs. There is currently too much emphasis on collateral based lending. The adoption of methods that place a greater focus on determining project viability and risk would lead the banks to discover projects worth funding that they are currently overlooking.
- 8) PFIs should also not be too quick to declare defaults on loans if the restructuring of a loan is possible. Currently, financial institutions are keen to claim for reimbursement from guarantors whereas if there was no guarantee, they would be forced to work with borrowers more to try to stave off a default and the accompanying loss. Helping new borrowers avoid default is good for all parties in the long term.
- 9) Guarantors thinking of starting small CGSs should consider partnering with credit guarantee companies such as the African Guarantee Fund whose systems, expertise and acquired knowledge can be leveraged instead of duplicating efforts and reducing the funds available to borrowers. Alternatively, multiple co-guarantors should

come together to form larger CGSs that can harness economies of scale. If this is not feasible, then the guarantor can partner with a smaller FI that values the increased business from using the scheme. However, this may mean investing in the small FIs technical capacity in SME and agricultural finance.

- 10) Guarantors should continue to invest in technical capacity for both borrowers and financial institutions. They should also work to develop closer relationships with PFIs aimed at increasing financial deepening by developing and sharing valuable macro level information, e.g. risk levels in the market and lessons learnt.

- 11) Guarantors currently active in Tanzania should further capitalize their schemes as the demand for credit in Tanzania's MSME and agricultural sectors is well in excess of the funds currently available at the existing CGSs.

- 12) The financial sector should come together to develop effective means of working with the government when policies are initiated that could adversely impact the sector.

1.0 Introduction

1.1 BACKGROUND

Access to finance continues to be a major challenge for small enterprises and the agricultural sector in developing countries. Given the importance to the economy of both small enterprises and agriculture, numerous policies and tools have been used to get credit flowing to these sectors. Some of these approaches include direct lending to farmers' small enterprises and interest rate subsidies, among others.

This report documents the findings of a review of the guarantee schemes in Tanzania. The review was conducted by Strategic Business Advisors (SBA) and commissioned by the Financial Sector Deepening Trust (FSDT).

The objectives of the review were threefold: to document the experiences, challenges and lessons learnt by the guarantee schemes currently or recently operational in Tanzania; to research and document best practices from guarantee schemes around the world; and finally to make any recommendations to the various stakeholders in Tanzanian schemes, on opportunities for improvement.

1.2 METHODOLOGY

Over a three week period, SBA conducted a series of face to face interviews with various financial institutions and guarantors of the schemes operating in Tanzania. Telephone interviews were conducted with individuals who could not be reached directly. For each scheme, SBA talked to at least one guarantor (some schemes have multiple guarantors acting in partnership) and also at least one participating financial institution. For some schemes, it was necessary to rely on other past reports on these schemes..

SBA also interviewed other stakeholders including government officials and the ultimate beneficiaries of some of the guarantee schemes, i.e. SMEs and farmer groups that benefited from guaranteed loans.

For the guarantee schemes operating outside Tanzania, SBA conducted a desk review of numerous guarantee schemes across the globe and documented those that offered unique and valuable lessons that could be implemented by FSDT and others in Tanzania.

1.3 LIMITATIONS OF THE STUDY

The process of identifying the guarantee schemes currently active in Tanzania was conducted through interviews with known guarantors, banks and borrowers that are currently participating in CGSs. It is possible though not very likely, that some GSs that are either new or limited in scope were overlooked.

Secondly, the information on GS design and performance was provided by either guarantors or partner financial institutions and could not be fully verified. This information is not comprehensive as both guarantors and PFIs were only willing to provide the information that they felt all parties were comfortable with,

to avoid undermining partnerships or violating non-disclosure agreements. There was also no uniformity in the information made available. While every attempt has been made to present the various schemes in a format that will facilitate comparison, some of the schemes may not have enough information to give a complete picture.

Finally, the research on guarantee schemes outside of Tanzania included information gathered from publications by reputable organizations such as FAO and the World Bank. This information was not independently verified during this review as the sources are considered credible.

1.4 REPORT STRUCTURE

In the following two sections, an overview of the environment in which GSs operate is given by reviewing the role of small enterprises and agriculture in the Tanzania economy, the policy and regulatory environment and the financial sector.

Section 3 reviews guarantee schemes in general and look at some of the related concepts and terminology that will be used in this report.

Section 4 documents the findings of Tanzanian guarantee schemes, looking at the active and inactive schemes, their differences and similarities, as well as an assessment of their performance and impact.

Section 5 features some important lessons learnt by Tanzanian schemes together with other general lessons from around the world.

This is followed by a documentation of the best practices related to every aspect of creating and operating a credit guarantee scheme.

Section 7 and 8 conclude the report with some recommendations to various stakeholders.

Annex 1 documents case studies of some schemes outside Tanzania.

The terms MSME and SME are used interchangeably in this report while credit guarantee schemes are sometimes referred to simply as 'schemes' or CGSs.

2.0 Tanzania – A General Overview

2.1 MSMEs AND AGRICULTURE IN THE TANZANIAN ECONOMY

Tanzania is the largest country in East Africa, with a total area of 956,000 km², making it the 31st largest country in the world, and 13th largest in Africa (CIA-The World Fact Book). The 2012 national census found that Tanzania had a total population of 44.9 million people, with 1.3 million of those living on the islands of Zanzibar

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Between 2001 and 2010, Tanzania's real GDP recorded an average growth rate of about 7%. In 2012, according to the World Bank, the economy grew at an estimated rate of 6.9% to a total GDP of US\$ 28.25 billion (\$1600 per capita). This trend is expected to continue with the country targeting an average growth rate of 8% between 2013 and 2016.

The importance of MSMEs for economic competitiveness and growth, employment and poverty reduction is widely recognized. The 2010 National Baseline Survey by the Ministry of Industry and Trade and FSDT reported that there are about 3 million micro and small enterprises in Tanzania, most of which are engaged in the trade and service sectors. These businesses employ more than 5.2 million people and almost 55% of them are owned by women. The same survey found that the most critical constraint cited by small business owners was insufficient working capital.

Agriculture is an important sector for the Tanzania's economy. Over 75% of the working population relies mostly on this sector. Agriculture contributes a sizeable proportion of the GDP (about 27%), a major source of foreign exchange earnings (about 30%) and food security. However, besides its importance to the economy and people's livelihood, the sector continues to face substantial challenges in terms of growth. One of these challenges is lack of finance.

AgFIMS Tanzania 2011 (an FSDT sponsored study) found that there were 2 million agribusinesses, 94% of which were producers, 1.4% processors and the rest provide agricultural services. Tanzania has a total of 44 million hectares of arable land of which only 23% is currently in use. While access to land for farming is not a problem, almost 40% of producers cited lack of capital to be the main reason why they did not use all their land for farming business. Most farming is on a small scale with very limited mechanization.

2.2 POLICY AND REGULATORY ENVIRONMENT

Tanzania's economic development is guided by the overarching Vision 2025 plan which states that "Tanzanians will have graduated from a least developed country to a middle income

country by the year 2025 with a high level of human development. The economy will have been transformed from a low productivity agricultural economy to a semi-industrialized one led by modernized and highly productive agricultural activities which are effectively integrated and buttressed by supportive industrial and service activities in the rural and urban areas" (Vision 2025, 1999, p. 2).

To achieve Vision 2025, the country has a Five Year Development Plan which points out that in order to achieve a GDP growth of 8% between 2012 and 2016, agriculture's growth rate will have to increase from 4.4% to 6% and that of industry from 8.6 to 9.4%. National Strategy for Growth and Reduction of Poverty II (NSGRP II) has set targets to reduce poverty in both rural and urban areas in Tanzania from 33.6 percent 2007 to 24 percent in 2015.

The Agricultural Sector Development Strategy (ASDS) is Tanzania's main strategy document for its agricultural sector. The main objectives include increasing farm incomes to reduce poverty while increasing food security and also creating an enabling environment for improved productivity and profitability in the agricultural sector. Alongside ASDS are other initiatives such as Kilimo Kwanza (agriculture first) and Southern Agricultural Growth Corridor of Tanzania (SAGCOT) that are also supposed to accelerate agricultural development. These are coordinated and monitored by the Ministry of Agriculture Food Security and Cooperatives.

Specific policy related to SMEs is documented in the Tanzania SME Development Policy of 2003 which emphasizes the centrality of SMEs in Tanzania's economic growth. The policy is structured on 7 pillars on which the government will promote SMEs. These include simplification of the legal and regulatory environment, improvement of physical infrastructure, rural industrialization and

access to finance. Action items under the access to finance pillar include establishing SME windows at existing FIs and developing financial products specifically targeted at SMEs. Regulation and monitoring of MSME policies is coordinated by the Ministry of Industry while the Small Industries Development Organization (SIDO), a parastatal organization, providing support services to small enterprises. These include enhancing capacity to access finance and markets, technical assistance and liaising with the government on behalf of small industries.

2.3 THE FINANCIAL SECTOR

Tanzania's banking sector embarked on a financial liberalization path in 1992 that allowed new entrants into the market and increased the degree of competition. This was after the enactment of the banking and financial institutions act 1991 that allowed private banks in the country. As at the time of this study, the Bank of Tanzania, the country's central bank and main regulator of the financial sector, listed 34 banks, 18 financial institutions and 3 credit reference bureaux as being currently active in Tanzania.

However, the sector remains quite imbalanced, with three commercial banks CRDB, NMB and FBME accounting for almost half of the industry's assets, and the top ten banks accounting for 80% of the industry's assets (Tanzania Banking Survey, 2012). However, in terms of branch networks, NMB has the biggest number (150), followed by CRDB and National Bank of Commerce with 76 and 53 branches respectively. These banks form the top tier of the banking system followed by other national commercial banks, then regional community banks and finally, the non-bank financial institutions. The top tier banks tend to have problems of excess liquidity while the lower ones suffer from a lack of liquidity.

Most of the large banks focus primarily on serving corporate customers. According to a 2013 report authored by World Bank researchers, Gunhild Berg and Michael Fuchs, lending to SMEs comprises only 14% of total lending by Tanzanian banks compared to 17.4% in Kenya. This is a common problem not just in Tanzania but across the continent. The African Guarantee Fund also estimates that only 20% of African SMEs have a line of credit at a bank.

According to the AgFiMS 2011 report, more than half of the agribusinesses surveyed were financially excluded, meaning that they did not have even basic services and products such as bank accounts. Only 30% had access to credit products or mechanisms. Similarly, the 2012 National Baseline Survey Report on MSMEs in Tanzania showed that only 10.6% of the surveyed small business owners had formal access to financial services, i.e. had an account or some sort of relationship with a financial institution supervised by a financial services regulator.

3.0 An Introduction To Guarantee Schemes

3.1 OVERVIEW

At a basic level, guarantee schemes work where there is significant demand for goods or services that goes unmet. This is usually but not always due to a perception of increased risk in providing the goods or services to a particular party, group or population segment. In such cases, a third party entity known as the guarantor (usually a government, donor agency or corporation) intervenes by taking on some or all of the risk perceived by the provider of goods or services. In essence, the guarantor provides a form of insurance (a guarantee) to the supplier assuring them of compensation in the event that any of the potential risks, such as a lack of performance or default are realized.

There are various forms of guarantee schemes. Some of the more popular ones are outlined below.

- Employment guarantee schemes are aimed at reducing poverty by providing skills to unskilled workers and guaranteeing them some form of limited employment and compensation. For instance, India's Mahatma Gandhi Rural Employment Guarantee Scheme, guarantees one unskilled worker per household in certain regions of India 100 days of employment in a year at a specified minimum wage. These unskilled workers are attached to jobs provided by various employers on the understanding that the government will pay their wages.
- Investment guarantee schemes are created to attract potential investors in areas that the guarantor is interested in developing. For instance, a country may insure investors against political risk by promising to reimburse any invested funds that are lost due to political events.
- Deposit guarantees provided by government entities in most countries as insurance for those that deposit funds with financial institutions. The deposit

guarantee scheme reimburses a specified amount of deposited funds in the event of a financial institution failing.

This review focused on the SME and agriculture sectors in Tanzania and around the world. In this context, credit guarantee schemes (CGSs) were found to be the most popular form of guarantee schemes in Tanzania. Most of this report is therefore dedicated to CGSs, while highlighting instances where other guarantee products have been introduced.

In a CGS, a guarantor puts up some capital to guarantee the extension of credit to an individual, group or section of the population. The guarantor implements an organizational structure and recruits partner financial institutions (usually banks and microfinance institutions). These PFIs are then authorized by the guarantor to extend credit (loans, overdraft facilities etc.) to the guarantor's target market with the understanding that if there is a default by a borrower on any transactions under the agreement, the guarantor will compensate the PFI for losses incurred.

The earliest records on CGSs show that they were started around the late 19th or early 20th century in Europe. Initially, they took the form of full credit guarantee schemes in which the whole risk of the borrower was assumed by the guarantor. However, over time and for reasons to be discussed in the following sections, full CGSs are now very rare. Instead, partial CGSs have been developed which cover a portion of the total risk. This portion is generally referred to as the coverage ratio and usually ranges anywhere from 30% to 85%.

A partial CGS can be defined as ‘a risk transfer and risk diversification mechanism: it lowers the risk to the lender by substituting part of the risk of the counterparty by that of the issuer of the PCG (the fund), which guarantees repayment of part of the loan upon a default event’. (Beck, Klapper, Mendoza, 2008). The risks undertaken by a credit guarantee scheme can be categorized as:

- Counterparty risk arising from the possibility of default by the borrower
- Portfolio risk arising from a lack of diversification in the loans guaranteed
- Liquidity risk which means the CGS may not have adequate funds to pay all claims submitted by PFIs
- Operational risks arising in the normal course of business e.g. mistakes in assessment of risk, technology malfunctions etc.
- Market risk whereby the CGS is impacted by events in the marketplace that are outside of its control.

CGSs that target MSMEs are usually created in response to market failure: financial institutions fail to respond to the demand for credit by MSMEs. Banks usually cite the following as the reasons they tend to avoid small enterprises:

- SMEs are not likely to have adequate collateral to secure their borrowing

- SMEs are perceived to be risky primarily because most are relatively young businesses struggling to establish themselves. The probability of failure is therefore deemed to be high. Information asymmetry also helps drive this perception. SMEs tend not to have documentation such as financial statements and business plans that banks FIs can use to assess their viability. Most developing economies also do not have established or comprehensive sources of credit information on SMEs.
- High transactional costs. Loan amounts for MSMEs tend to be small and yet the cost of appraising those loans is more or less the same as that of much bigger loans to corporate customers. The relative transaction cost is therefore perceived to be high.

Banks also tend to avoid working in agricultural finance for the following reasons:

- Agriculture is vulnerable to external shocks such as unpredictable weather and volatile market prices. Agricultural finance also requires technical knowledge that the banks often do not have.
- Poor infrastructure in developing countries means that banks experience a high cost of delivering service to farmers. Most farmers are located in remote areas with poor access where banks are reluctant to establish branches.
- Most farming in developing countries is small scale and unsophisticated resulting in poor yields. Potential transaction sizes are therefore small and not worthwhile for banks.
- Farmers often do not have collateral. If they do have land, they are reluctant to use it to raise debt as they fear losing it if they are unable to repay the debt. In some countries however, this problem has been overcome by acceptance of different forms of collateral. Livestock has been used in Rwanda and Kenya.

The guarantor steps in to address this market failure driven by a public policy agenda to promote certain sectors of the economy or a social interest in boosting incomes and helping small enterprises expand. Over time this translates into greater benefits for the whole economy.

On the other hand, financial institutions usually sign up to participate in a CGS because they are able to expand their business safely into sectors and regions that they would otherwise not have considered, e.g. SME lending. In a perfect environment, the PFI accrues three benefits from a CGS:

- i) Compensation in case of loan default
- ii) The bank can save some capital because the guarantee fund takes the place of its capital reserves in backing loans issued
- iii) By tapping into the guarantor's funds, the FI is less constrained by the regulator's Single Obligor Limit. This is the maximum amount that a bank is allowed by the regulatory authority to lend to a single borrower

3.2 CREDIT GUARANTEE SCHEME TOPICS AND TERMINOLOGY

3.2.1 Retail versus portfolio CGSs

The nature of the relationship between a guarantor and a PFI can be defined by their functions within the scheme. In a portfolio CGS, the guarantor sets aside a specific amount of capital for the PFI to guarantee loans that meet specific pre-determined criteria. For example, the CGS sets aside \$1 million to guarantee 50% of the loan amount for agricultural loans not exceeding \$5,000 and with terms of one year or less. The PFI provides the matching funds and originates, appraises, approves and monitors the loans that meet the guarantor's criteria. The PFI then sends regular reports to the guarantor as well as claims on any defaulted loans. In a strict portfolio CGS, the guarantor's role is limited to reviewing the

reports, occasionally auditing the loan portfolio and paying claims.

On the other end of the spectrum is a retail portfolio. In this case, the guarantor receives individual applications for guarantees from the PFI, conducts his own appraisal and gives or denies approval. In some CGSs, the borrower goes directly to the guarantor to get approval first before going to the PFI. While the PFI's credit appraisal processes tend to involve analysis of financial statements and collateral value, i.e. quantitative analysis, the guarantor will tend to supplement this with more qualitative analysis such as assessing the prospects of the project to be funded and the quality of its management.

Most CGSs tend to lie somewhere in between the two ends of the spectrum. A retail CGS is more resource intensive as the guarantor has to conduct a level of due diligence which calls for investment in technical capacity. For this reason, most CGSs in developing countries tend to be portfolio guarantees that rely on the PFIs credit processes.

3.2.2 Cash cover guarantees and paper guarantees

A cash cover guarantee requires the guarantor to deposit cash (the amount is proportional to the coverage ratios agreed and the amount of credit disbursement that the guarantor is targeting) in a PFI account. In this way, the PFI is assured that the guarantor does indeed have the funds to back the guarantee. Typically, these funds are put in an interest earning account with the interest reverting back to the guarantor.

However, some guarantors may be recognized as having a very strong credit (e.g. an 'A' rating by a recognized agency) and can issue guarantees simply by signing a commitment to pay claims on any defaults. This is usually the

case for governments and large international financial institutions which will give the PFI a letter of guarantee indicating a commitment to pay claims submitted for defaults on loans issued under the guarantee scheme.

3.2.3 Leverage

In the context of credit guarantee schemes, the leverage ratio refers to the ratio of the cumulative loans generated under the scheme to the schemes capital. If a scheme has a total capital of \$1 million and in one year is able to generate \$2million in loans, then it is said to have a leverage ratio of 2. This ratio is a function of the following:

- Cash guarantees generally though not always have lower leverage than commitments on paper simply because a cash cover guarantee is limited to a fixed amount of funds deposited at a bank. But with a signed commitment the guarantor is free to commit as much as his credit will allow and partner with multiple institutions.
- Tenure of guaranteed loans. Short term loans result in a higher churn or turnover which allows more lending.
- The higher the coverage ratio, the more the guarantor's capital is tied to a particular loan.

3.2.4 The various roles of government in CGSs

Governments can be involved in CGSs in multiple ways. First, they can be directly involved by funding and/or operating a guarantee scheme. The government can be involved as a regulator or by offering counter guarantees in support of a CGS. Counter guarantees are secondary measures assuring CGS beneficiaries that in the event that a guarantor is unable to pay claims, the counter guarantor would do so. This only happens in instances where the government wants the guarantor to take on more risk or potential

losses beyond the guarantor's normal scope of business. In this case, if the potential losses are realized, the counter guarantor takes the first loss.

Beyond direct involvement, the government provides the infrastructure necessary for the proper functioning of the economy and financial sector, such as an efficient judicial system that can enforce property rights.

3.2.5 Regulation of CGSs

Guarantee schemes play an important role in the financial sector and there has always been a debate as to whether they should be considered to be financial institutions and regulated as such. The argument against this is that CGSs are not deposit taking institutions; their collapse would not lead to a financial sector crisis.

Another argument against treating CGSs as financial institutions is that it would make them subject to the same capital requirements as other FIs. This would limit the leverage and subsequent impact possible. Proponents argue that regulation would increase the credibility of CGSs because there would always be an assurance of their ability to pay claims.

Regardless, CGSs in many developed countries are large enough to make regulation necessary. The regulator is usually the same central bank that oversees other financial institutions (e.g. in France) but it can also be a different authority specially created by law to oversee guarantee schemes. In Italy for instance, large CGSs are supervised by the Bank of Italy while the smaller ones are overseen by an external body that is itself supervised by the Bank of Italy.

The main aspects of a regulated CGS are:

- The regulator ensures that the guarantor's capital is adequate to pay potential claims at all times. The levels of leverage should be reasonable based on history,

the prevailing economic climate or on standards at other financial institutions.

- The CGS should have adequate control and monitoring mechanisms to keep track of risk levels in the portfolio of guaranteed loans and corresponding loan loss provisions.
- Financial Statements should be in an approved format that comprehensively communicates the schemes financial position and should be audited.
- The scheme's staff should be fully qualified and have integrity just as is required of financial institutions.

3.2.6 The role of other institutions

Consultancy firms are usually retained by CGSs to conduct market research prior to the implementation of a scheme, to provide training to borrowers or PFIs, and to conduct impact assessment either while the scheme is still in operation or after it has been wound down.

Consumer groups formed by borrowers are also sometimes involved prior to the formation of credit guarantee schemes and sometimes in the governance of the scheme by being allocated a seat on the board.

3.2.7 Impact and added value

There should be continuous verification that guarantee schemes are having the desired impact. This can be ascertained not just by reports from PFIs, but also by conducting impact assessments. These can be approached in the following ways:

- The number of borrowers served and cumulative amount of loans issued.
- A key success criterion is whether the CGS is adding value. On a micro economic level, this means getting credit to projects, enterprises or individuals that would otherwise not be able to access credit. At the macro level, it means job creation, wealth etc. contributing

to economy as a result of credit flowing to new enterprises. While macro level added value is harder to evaluate, it can be ensured at a micro level within the design of the guarantee scheme. For example, ensuring that only borrowers with inadequate collateral get covered under the scheme.

- Impact on banks. The main objective of most CGSs is to get financial institutions to start lending to those sectors that the FIs ordinarily consider too risky. At some point however, the term of the scheme must come to an end. If the experience of participating FIs gained during tenure of the CGS has been positive and they continue to serve those sectors the scheme will be deemed successful.

3.2.8 Alternative guarantee products

Established and successful GSs tend to develop new products to meet specific demands of the market. Some alternative products of interest include:

- Guarantees for inter-bank lending. Top tier banks usually have a lot of liquidity while the smaller banks and microfinance institutions do not. This product guarantees the top tier banks that the loans to the lower tier banks will be paid. It also allows the lower tier institutions to get more liquidity and create more credit for their target markets.
- Bond guarantees. Medium sized enterprises can float commercial paper and bonds and a CGS will offer a guarantee in case the borrower cannot pay.
- Guarantees for equipment leasing. This is especially effective in agricultural financing. Most agribusinesses simply cannot afford equipment such as tractors. The guarantor either through its own leasing business or others will guarantee payment by a lessee of such equipment.
- Equity guarantees – offered mainly to private equity companies as an incentive for them to invest equity in SMEs they

may deem too risky. The guarantee assures them that they will at least recover the funds invested if the SME fails.

- Securitization of SME loans. GSs offer guarantees to secondary market buyers who will buy bundles of SME loans from FIs. These buyers could be pension or insurance companies who want income from the SME loans. By offering a guarantee on these loan bundles, the CGS makes them more attractive to the secondary market buyer. The biggest impact of this tool is that it allows FIs to offload their current portfolios quickly and create new loans.

3.2.9 Mutual Guarantee Associations

These are organizations formed by small enterprises which come together to form a GS that can guarantee their loan applications at financial institutions. The membership makes periodic payments which form the capital of the GS. From there on, the MGA works like any other GS except that it only serves the interests of its members. Though very popular in Europe, there is no evidence of any MGA operating in East Africa but the concept is interesting and worthy of support by donors.

3.3 CONCERNS REGARDING CREDIT GUARANTEE SCHEMES

CGSs have been around for a long time. Gradually, their overall performance has been brought into question. Some of the arguments against CGSs are:

- i) CGSs have been criticized as inherently unsustainable primarily because they are perceived to subsidize risk and costs. For many schemes, the total cost of their operations and claims is always well in excess of the income they earn from fees and investment earnings. This is because with the cost of credit to SMEs or other

borrowers, perceived as risky, is already too high. The CGSs avoid making this worse by passing on their costs in full. Also, some donor funded CGSs usually have a social agenda and may therefore provide borrowers with credit at similar or lower rates than established borrowers. This can happen even where their risk profile is higher than that of established borrowers. These practices are unsustainable in the long run as the guarantee scheme needs to be continually funded from external sources which may not always be available. Finally, donor and government funded CGSs are sometimes run as projects rather than independent entities. This means that the schemes cannot adjust to market realities quickly enough as dedicated decision making and focused resources are not immediately available.

- ii) In both developed and developing countries, a lot of CGSs are funded and/or administered by the government. These schemes tend to be heavily influenced by political considerations. Subsequent decisions may be far from optimal, not just for the sustainability of the scheme, but also in terms of the misuse of public funds used to fund these schemes.
- iii) CGSs can distort markets by introducing products or services with features that are not sustainable. For instance, a guarantor offering loans at lower than market interest rates will attract a lot of borrowers. This will be detrimental to other lenders who will either try to respond or suffer losses. This would be a good thing for the market if the new guarantor was not subsidizing the loans, and stayed in the market for the long term. However, this is rarely the case and when such guarantors leave the market, there is a negative impact on both borrowers and lenders as rates are adjusted back to sustainable levels. Some critics have also argued that CGSs bring about a distortion of competition because they

allow small businesses to access the credit that enables them to compete with larger rivals. However, they are not paying the full cost of accessing that credit. For instance, SMEs may be able to get guaranteed loans without having invested in the same financial systems that allow larger businesses to produce reliable financial statements.

- iv) CGSs are also often accused of creating moral hazard by taking on the risk that would otherwise be borne by financial institutions, CGSs give the banks an incentive to take on excessive risk. This phenomenon is especially prevalent when the guarantor's coverage ratio is high or where the FI, through use of multiple guarantees (co-guarantees) and/or collateral has greatly reduced or eliminated its risk. In such a situation, the FI can afford to take on very risky projects without bearing the cost of doing so. Moral hazard can also refer to the fact that when borrowers know their loans are guaranteed, they are more likely to misuse the money since they assume that someone else will pay if the money is lost.

These criticisms have led CGSs to redesign their structures in order to address the issues raised. The result is that modern CGSs, while working towards the same goals, have adopted a much more commercial or market orientation, addressing the concerns about sustainability. This market approach is characterized by:

- Independent governance of the CGS by qualified officers whose sole responsibility is to ensure the success of the scheme. The CGSs are either registered companies with independent boards or are created by special statutory laws to be free of interference from the government.
- Modern GGSs strive for financial sustainability by ensuring that their operational costs are passed on to the extent that the market can bear. This is apparent in the form of fees to the PFIs, the borrower or

both. Such fees are also not usually uniform and are priced to reflect the different risk levels associated with specific borrowers, sectors and PFIs. Where a CGS has multiple PFIs, those with better credit appraisal and monitoring processes will be charged lower fees than other PFIs whose processes are found to be below par. The CGS also manages the risk it takes on by using sophisticated risk management techniques including diversification and re-insurance.

- Awareness and responsiveness to market needs through use of market research and development of new products as demanded by the market. This ensures that the CGS remains relevant and generates multiple revenue streams to sustain itself.
- Reduction of information asymmetry by creating or working with credit reference bureaux. Established guarantee funds/schemes, by virtue of working with multiple PFIs over a long time, develop databases of credit information that allow PFIs to make much more informed decisions. This information tends to reduce risk in the system which is good for the sustainability of the fund. Most of the international CGSs reviewed in this report (annex 1) have either an in-house credit reference bureau or have spun off one during the process of development.

A recent report (FAO, 2013) summarizes this approach stating that 'emerging experience shows that GFs should have a clear commercial orientation, even if the initial capitalization is secured by donors. For this reason, the usual dichotomy of public versus private is much less important than is keeping both government and the donors out of the management and day-to-day affairs of GFs.'

4.0 Guarantee Schemes In Tanzania

4.1 OVERVIEW

In the course of carrying out this review, SBA met with the participants and stakeholders of various guarantee schemes in Tanzania. For each guarantee scheme, SBA interviewed at least one of the participating financial institutions as well as the guarantor, or at least one of them where there were co-guarantors. The GSs chosen were restricted to those that targeted SMEs and agriculture even though there are numerous other guarantee products in Tanzania. These include the energy sector guarantees offered by the World Bank and guarantees for large, high risk projects in the public and private sector offered by Africa Trade Insurance. In the final analysis, two schemes were identified that have been operating for less than a year, eight that have been in operation for longer than a year, and three that have either been suspended or ceased operations.

Below is a summary of the GSs which were identified and about which information was available.. Annex 1 offers case studies of some guarantee schemes outside Tanzania.

Table 4.1 Sources of funds

Source of funds	Guarantee Scheme Name	Participating Financial Institution	SME or Agriculture	Actual/Est. Size of Fund in Tanzania (USD)	Status
FSDT	SME Credit Guarantee Zanzibar	FBME	SME		EXPIRED
AGRA/FSDT	Agro-dealer Credit Guarantee Scheme	NMB	Agriculture		EXPIRED
Government of Tanzania	SME Credit Guarantee scheme	Various	SME		SUSPENDED
Rabobank	Sustainable Agriculture Guarantee Fund (SAGF)	NMB	Agriculture	1.3 million	ACTIVE
AFD	ARIZ	Bank of Africa	Both	15 million (est.)	ACTIVE
AGRA/Kilimo Trust/OFID	Agricultural Credit Guarantee (ACG)	Stanbic Bank	Agriculture	2.5 million	ACTIVE
Government of Tanzania	Export Credit Guarantee Scheme (ECGS)	Various	Both	35 million	ACTIVE
DANIDA	PASS	Various	Agriculture	25 million	ACTIVE
	SME & Microfinance CGS	CRDB	SME	7 million	ACTIVE
	Women Access to Finance	CRDB	Both	1.25 million	ACTIVE
DANIDA/ Spanish Govt./ AfDB	African Guarantee Fund (AGF)	Various	Both	5 million (Est)	ACTIVE
USAID/AfDB	USAID/AfDB	CRDB	Agriculture	20 million	ACTIVE
USAID-DCA	USAID-DCA-NBC	National Bank of Commerce	Both	10 million	ACTIVE
Estimated Total Guarantee Capital				US\$ 122 million	

The table above shows that the biggest participants in the Tanzanian GS arena are the Government of Tanzania and DANIDA, each having invested approximately US\$35 million in active schemes. The government will soon revive the suspended SME Credit Guarantee Scheme making it the biggest guarantor in Tanzania. Other major guarantors include USAID, the African Development Bank (AfDB) and Agence Française de Développement (AFD).

4.2 CREATION AND IMPLEMENTATION OF TANZANIAN GSS

4.2.1 Conception and setup

Some of the CGSs above such as USAID-DCA, SAGF and ARIZ are in Tanzania as part of international guarantee schemes while others such as the AGF and ACG are regional initiatives covering multiple countries within Africa. It was not possible to determine how these schemes were conceived and established. A few schemes however, come about as solutions to unique challenges identified in Tanzania. A perfect example of this is the Agro-dealer credit guarantee scheme funded by AGRA and FSDT. This scheme came about as a potential solution to a problem that had been identified at a stakeholders' workshop; farmers were not able to get farm inputs in a timely manner or in the right quality and quantities.

The proposed solution was to provide support to local agro-dealers who given their close proximity to farmers, would be able to provide the required inputs efficiently. The agro-dealers needed working capital support and as such it was agreed that they should be able to access credit facilities at a bank that had a wide network and experience working with farmers. NMB satisfied these criteria while AGRA and FSDT stepped in to provide guarantees for the credit facilities.

More stakeholders were brought in to strengthen other aspects of the scheme. For instance, it was noted that the agro-dealers had low financial literacy and business acumen. To strengthen their capacity, Citizens Network for Foreign Affairs (CNFA) was brought on board to provide training and certification for the dealers before they could be financed. Similarly, it made sense to include the government as a stakeholder, as it already had a voucher system that helped provide subsidized inputs to farmers. Finally, Norfund acted as a coordinator for the entire set up process. The scheme was successfully launched and went on to achieve significant success in meeting the objective for which it was created.

4.2.2 Partner selection

Tanzanian schemes have recruited partner financial institutions in various ways:

Table 4.2 Partner selection process

Credit Guarantee Scheme	Partner selection process
ECGS SME Credit Guarantee Scheme	Both schemes are government funded and as such are open for participation to all registered financial institutions
Women Access to Finance SME and Microfinance CGS SAGF	The DANIDA schemes have only one partner, CRDB in which DANIDA has significant ownership. Similarly SAGF has only NMB as its partner financial institution as Rabobank holds a significant ownership stake in NMB.
USAID-DCA USAID/AfDB	USAID did not offer details on selection process
PASS	Started at CRDB due to relationship between DANIDA and CRDB. Subsequently expanded by adding one PFI at a time to its current seven PFIs. Selection criteria detailed in best practices section.
African Guarantee Fund	Has multiple PFIs in Tanzania and also has the best selection process of all schemes reviewed. Process is detailed below as a best practice.
ARIZ	Currently has only one partner, the Bank of Africa, the result of an existing partnership with the bank in West Africa. Selection criteria highlighted in best practices section.
Agricultural Credit Guarantee	In Tanzania, the only partner is Stanbic bank. This is a result of an agreement between the guarantors and Standard Bank of South Africa. Details of selection process are not available.

4.2.3 Guarantee Framework agreement

No confidentiality agreements were made available to SBA in the course of the review due to concerns about violation of confidentiality agreements.

4.2.4 Claims processing

The claim submission and processing rules differed significantly among the schemes. There are a variety of options available to CGSs

for processing PFI claims. These range from immediate payment upon claim submission to payment after the PFI has gone through all recovery measures. Most of the active CGSs use a variation of the same approach - paying a portion (usually 50%) of the claim within 60-90 days and then waiting for the bank to go through all recovery measures before paying the guarantor's share of the remaining loss. If the recovery efforts yield more than the guarantor has already paid, then a refund is issued by the PFI.

Table 4.3 Claims processing

Credit Guarantee Scheme	Claim submission and processing details
Agricultural Credit Guarantee	Claim only submitted after all loan recovery processes have been executed and completed. Process can take up to a year given that there are three guarantors. Kilimo and AGRA process their portion of the claim first (can take up to 4 months to pay) and only then does the remaining claim go to OFID (can take up to 7 months to pay)
ARIZ	Claim submitted upon default. 50% of the claim is paid within 60 days while the balance is processed after all recovery processes have been completed.
SAGF	Claim only submitted 90 days after all loan recovery processes have been executed and completed.
AGF	50% of claim paid within 15 days of submitting claim. Balance is paid within 90 days after all recovery processes have been completed.

4.2.5 On-going relationship with PFIs

After signing the guarantee framework agreement, the relationship between both parties is mainly limited to submission of periodic reports by PFIs and field visits by the guarantors. This is because most of the Tanzanian schemes are portfolio based and need less communication with the guarantors than retail schemes.

One exception is PASS which works with borrowers to improve the bankability of their loan applications and introduces the borrowers to the PFIs.

4.3 TYPES OF SCHEMES IN TANZANIA

4.3.1 Classification according to administration

- **Public guarantee schemes:** are capitalized using public funds and run by an administrative unit of the government. The objective of these schemes is usually to pursue a public policy goal such as increasing exports or promoting entrepreneurship. The Export Credit Guarantee Scheme and SME Credit Guarantee Scheme were both funded by Tanzania's Ministry of Finance and administered under an agency agreement, by the Bank of Tanzania. The latter scheme was suspended in 2008 due to some capitalization and structural problems. The ECGS is still active and making a significant impact, though it is not without its problems.
- **Credit Guarantee Companies/corporate guarantee schemes:** although these have been created and capitalized by multilateral and bilateral development agencies (donors), they exist as independent registered companies governed by boards of directors, and having their own governing regulations such as articles and memoranda of association. They are much more commercially oriented than the schemes in the other categories and

strive to sustain themselves using internally generated funds. This means that they charge higher fees for their services compared to other CGSs because they pass on more costs to PFIs and borrowers. Two such companies are currently operating in Tanzania. Private Agricultural Sector Support (PASS) Limited initially started in the year 2000 as a DANIDA programme, but in 2007 was incorporated as a Trust under Tanzanian law. DANIDA remains involved through a founders committee in the board of directors. It has veto powers but largely lets the company run its own affairs. The African Guarantee Fund (AGF) was started in 2012 with funding from DANIDA, African Development Bank (AfDB) and the Spanish development agency (AECID) but is incorporated in Mauritius. The fund also has strong partnerships with other institutions such as the UK's Department for International Development (DFID) to improve the technical capacity of both SMEs and financial institutions

- **Donor guarantee programmes:** all other CGSs in Tanzania fall into this category. These are usually funded and run as a project or programme by donor countries through their international development agencies and/or their affiliated development banks. Two unique schemes in this category are the DANIDA funded SME and microfinance schemes which are not administered by DANIDA but by CRDB's SME department and CRDB Microfinance Company Ltd., a subsidiary of CRDB.

The motivation behind these schemes is usually a social one such as poverty reduction. The development agencies that are active in CGSs include DANIDA (Danish government), USAID (US government), AFD (French government) and AECID (Spanish government). Other donor countries and agencies are also involved though not directly through their own programmes. For instance, the Dutch Ministry for Development

Cooperation is involved in the SAGF through Rabobank, a major Dutch commercial bank and significant shareholder of Tanzania's National Microfinance Bank (NMB). The Swedish International Development Cooperation Agency (Sida), has funded guarantee schemes that were implemented and administered by FSDT. The African Development Bank though not considered a donor agency, has entered into partnerships with several others such as USAID and DANIDA as a co-guarantor.

There are also instances of CGSs that are the result of public-private partnerships between the government and donors. The Kilimo Biashara scheme in Kenya is a good example where the government of Kenya injected funds into a scheme that was originally funded by AGRA and IFAD.

4.3.2 Agricultural versus SME credit guarantee schemes

The schemes can also be categorized according to their target sectors i.e. agricultural or SME. Of the ten active CGSs only the SME scheme at CRDB explicitly avoids agriculture. On the other hand, four schemes are exclusively focused on agriculture and agribusinesses; SAGF, ACG, PASS and the USAID/AfDB credit guarantee at CRDB. All the others are open to all SMEs including those in the agricultural sector.

Though both agriculture and SME schemes are very similar in structure, there are some differences:

- Collateral is easier to come by and is also more varied for agricultural transactions. Most PFIs in agricultural schemes reported that they were working with warehousing systems to store produce. The warehouse receipts for such produce are accepted by banks as collateral (70% to 90% of the receipt value) though most banks reported difficulties selling the produce upon default. SME

schemes reported that borrowers typically had little or nothing to offer for collateral.

- Most loans guaranteed under agricultural schemes tend to be more short term in nature, usually less than a year in synch with agricultural cycles. Loans tend to be used for securing farm inputs or bridge loans for warehousing harvested produce until market conditions (commodity prices) are right. SME credit tends to be in the form of an on-going line of credit to finance working capital or a medium and long term loans for capital expenditure.
- As most loans tend to be short term and are backed by warehoused produce as security, guarantors of agricultural schemes are more likely to require PFIs to go through all loan recovery measures before settling any realized default losses. This warehoused produce can be sold quickly by the PFI or its agent before the guarantor can settle the final realized loss. This is the case for both the ACF and SAGF (claims submitted 90 days after recovery process).
- Default rates are much higher (almost always in excess of 10% and as high as 30%) for agricultural schemes due to the unpredictability of weather, produce prices and other external shocks such as government policy. Default rates on SME transactions averaged between 5 and 10% after all recoveries had been made.
- Grouping of borrowers was much more prevalent under agricultural schemes whereby banks lend to a group of farmers as one entity. PASS has been very adept at putting together such groups. No grouping was reported under SME schemes except in instances where there was lending to savings and credit cooperatives (SACCOS).

The main crops financed by the guaranteed loans include cashew nuts, sugarcane, coffee, sunflower and some food crops, including rice and maize. Tobacco and alcohol related

products are avoided by all the donor funded schemes, although ECGS covers both tobacco and barley.

4.3.3 Comparison of active CGS features

Table 4.4 Comparison of active CGS features

Guarantee Scheme Name	Portfolio or retail	Annual Risk sharing Fees	Coverage ratio	Borrower interest rate	Loans Interest coverage
Sustainable Agriculture Guarantee Fund (SAGF)	Portfolio	1-2%	75%	Market rates	No
ARIZ	Retail & portfolio	1.6%	50-75%	Market rates	Yes
Agricultural Credit Guarantee (ACG)	Portfolio	1%	Varies by year	Up to 3 % points lower than market	No
Export Credit Guarantee Scheme (ECGS)	Portfolio	1%	50-75%	1% point discount	No
PASS	Starts as retail before portfolio is authorized	4%	30-80%	Market rates	Yes
SME & Microfinance CGS	Portfolio	None	50-80% for SMEs. 10% for microfinance	Market rates	Yes
Women Access to Finance	Portfolio	None	50%	Market rates	Yes
African Guarantee Fund (AGF)	Portfolio	2-4%	50%	Market rates	Yes
USAID/AfDB	Portfolio	0.625%	50%	Market rates	No
USAID-DCA-NBC	Portfolio	Unknown	50%	1-2% point discount	No

Most of the CGSs also specifically exclude lending to enterprises involved in activities such as real estate, gambling and weapons. Portfolio versus Retail

Portfolio versus Retail

All the guarantee schemes identified offered portfolio guarantees to their PFIs. However, both ARIZ and PASS began their relationship with a new PFI using the retail model. Once confidence is established, the PFI is then given the go-ahead for a portfolio guarantee. In the case of ARIZ, AFD has approved a portfolio guarantee for the Bank of Africa, though this has not yet been implemented.

Cash cover versus signature commitments (commitments on paper)

ECGS and all other Government of Tanzania schemes are commitments on paper. Similarly, the schemes in which the African Development Bank is a partner, i.e. AGF and the USAID/

AfDB scheme at CRDB, are both commitments on paper backed primarily by the recognition of AfDB's recognized credit rating. All other schemes in Tanzania are cash cover schemes.

Fees

Most schemes have one risk sharing fee charged to the participating financial institutions, which may or may not pass on to the borrower. However, AGF also have other fees such as origination (to process an application to be a PFI) and a utilization fee (penalty for failing to use guarantee as agreed). Some schemes such as PASS also has a fee charged directly to the borrower for assistance in business plan preparation and loan application. Fees are usually charged on outstanding loan amounts but can also be charged on the principal only.

Interest rate charged to borrower

Most schemes either leave the interest rate decision to the PFI or request a small interest rate discount. Some schemes give up to 3 percentage points lower than the prevailing interest rates, e.g. 15% when the market is charging 18%.

Guarantee on loan interest

Some schemes such as SAGF, ACG, ECGS and USAID cover only the principal on the loan, while the other schemes guarantee both the principal and some or all of the interest.

Coverage ratios

Most of the CGSs offer the standard 50% coverage. However, a few others offer higher coverage rates. ECGS and SAGF for example, both cover 75% while others such as PASS and DANIDA's SME guarantee fund will go up to 80% in specific instances, such as loans to women's groups.

Leverage

The average target leverage among the active CGSs is two times. This is because most of the CGSs have a coverage ratio of 50% and also need to deposit funds at the PFIs which institutions can then match. However, the schemes guaranteed by AfDB and USAID as well as the Government of Tanzania have target leverages between 2 and 5 times. FSDT/AGRA Guarantee scheme with NMB had a leverage of 4 times the guarantee amount. ECGS has the highest target leverage of 5 times. This is achieved by not having to make actual deposits at banks (guarantee is on paper), and also focusing mainly on short term lending i.e. loans of less than one year, which result in a higher churn. Capital of \$122 million can therefore be expected to guarantee loans at any one time of at least double that amount. Over an extended period, the total amount of guaranteed loans is greatly multiplied as some

are paid off and new ones are issued. ECGS for instance, with its capital of Tsh 56 billion, has guaranteed loans of almost a trillion shillings since inception.

Products

All these CGSs offer traditional loan guarantees to SMEs and individuals. However, there are a few other products in the market beyond traditional guarantees:

- i) DANIDA Microfinance guarantee covers lending to SACCOS which offer loans to their membership in turn. These loans are for very diverse purposes including school fees, medical expenses etc.
- ii) PASS linkage banking guarantee covers lending by top tier banks in Tanzania, to lower tier banks with the objective of easing the flow of liquidity from those banks with too much liquidity to those that have liquidity problems. AGF has a similar resource mobilization product.
- iii) Equity guarantees offered by both AGF and PASS to ensure equity investments in SMEs (PASS guarantees restricted to agribusiness SMEs).
- iv) Hire Purchase guarantee offered by PASS for farming equipment.

4.4 PERFORMANCE OF THE GUARANTEE SCHEMES

Data from impact assessments of their CGSs was requested from guarantors, but most were either reluctant to share the information or had not conducted any assessments. Data about the amount of guarantees and loans issued was more readily available, and this information is given for the respective CGSs.

Table 4.5 Performance of the guarantee schemes

Guarantee Scheme Name	Capital	Total guaranteed loan amount	Default Rate
Agro-dealer Credit Guarantee Scheme	\$2.1 million	\$8 million	3.5%
SME Credit Guarantee scheme	Tsh 3.1 billion	Tsh 6.5 billion	unknown
Sustainable Agriculture Guarantee Fund (SAGF)	1.3 million	\$1.3 million	Less than 1% after recovery
ARIZ/Bank of Africa	15 million (est.)	No figures given	Zero
Agricultural Credit Guarantee (ACG)	2.5 million	No figures given	25%
Export Credit Guarantee Scheme (ECGS)	35 million (Tsh 56 billion)	Tsh 984 billion	5% overall rate after recovery according to BoT. PFIs cite higher rates
PASS	25 million	Tsh 100 billion	No figures given
African Guarantee Fund (AGF)	7 million	Too new	Too new
USAID/AfDB	1.25 million	\$19 million	No figures given
USAID-DCA-NBC	5 million (Est)	Too new	Too new

No guarantor had data on the number of new borrowers accessing credit for the first time, a critical measure of added value. Likewise, there were no numbers for employment created, but there was anecdotal evidence of increased production. For instance, PASS took credit for increasing sugar cane production in certain areas by up to three times due to the provision of credit.

4.5 CAPACITY OF THE PARTICIPATING FINANCIAL INSTITUTIONS

Although financial institutions were not very forthcoming about the specifics of their credit processes, some of the guarantors were willing to give their opinions of the processes at their partner FIs. Based on this feedback, the following conclusions can be made:

- There is a need for re-orientation of most FIs to develop processes that are more suitable for SME and agricultural financing. Both the financial institutions and guarantors are agreed that more technical assistance for banks is needed in this aspect. For a long time, most if not all of Tanzanian financial institutions have had a very strong corporate orientation which is reflected in their credit processes. Even when dealing with SMEs, the FIs tend to use appraisal models that emphasize

issues such as history with the bank and collateral, areas in which SMEs are weak.

- International organizations and FIs that have a significant shareholding in local FIs have ensured the implementation of improved credit processes. DANIDA holds a significant stake in CRDB and the bank attributed its low defaults to strong credit processes implemented with DANIDA's assistance. Rabobank International holds a significant stake in NMB which has benefitted by improving its processes.
- Both SME and agricultural financing need specialized focus. The best banks to partner with are those that have developed departments or desks for these sectors. Good examples include NMB, CRDB and the Bank of Africa.
- Some FIs with help from guarantors, have adjusted their processes to meet the guarantor's expected standards. A good example is the Tanzania Women's Bank which made changes to its processes so that it could work with the African Guarantee Fund.
- It should not be assumed that all large banks have the capacity or desire to work with SMEs. Some banks have explicitly indicated that they do not have the resources, processes or policies to work with SMEs at the moment.
- All financial institutions could benefit from capacity enhancement in agricultural

finance. Some banks pointed out that their agricultural finance desks are lacking in technical knowledge of agriculture. On the other hand, SAGF attributes most of its success in agricultural financing to its high degree of technical knowledge. As a result they are able to determine which agricultural sectors to develop credit products for and how to design those products.

4.6 SUSTAINABILITY OF THE SCHEMES

As mentioned in the introduction, sustainability of credit guarantee schemes is a key issue that keeps reappearing. To address it, CGSs have been given a more commercial orientation, so that they are capable of sustaining themselves. This commercial orientation has meant relying less on outside funds and raising sufficient revenues by charging higher fees to borrowers and PFIs. The two credit guarantee companies in Tanzania are the only schemes that are operating in this manner. Both AGF and PASS charge fees of up to 4% which is extremely high compared to the 0.625% charged by USAID. These two schemes have also been very market responsive offering new products as demanded by the market such as equity guarantees and leasing/hire purchase guarantees. They are also run by independent boards meaning that their leadership is always aware of and responsive to the challenges facing the companies.

The donor funded programmes in Tanzania continue to be highly dependent. Although some of these donors have very deep pockets, there is no guarantee that funding will always be available. However, these schemes are designed to have a fixed amount of capital, a low leverage and run on the basis of renewable terms of between three and ten years. This means that as long as they manage their claims wisely, they should be able to get to the end of their terms without any problems, at which

time the decision about whether or not to renew them will be made.

The government schemes are struggling with both high levels of claims and discontent from PFIs due to slow claim processing. Without recapitalization and a change of how they are run, these schemes may not be sustainable in the long run.

4.7 ECONOMIC, REGULATORY AND POLICY ENVIRONMENT IMPACT ON CGSS AND THEIR RESPONSES

The following have been cited by various CGSs and other Tanzanian financial institutions as inhibiting their effectiveness and ultimately, the flow of credit in Tanzania:

4.7.1 BoT's recognition of first class banks

Tanzania's Banking and Financial Institutions Act 2006 defines a first class international bank as, 'an international bank that has a minimum long-term rating by internationally recognized rating agencies of "A" or above'. Based on this definition, institutions such as AfDB, AFD, USAID, and DANIDA should be recognized as first class international banks and allowed to issue guarantees backed only by the strength of their credit instead of having to deposit guarantee funds at PFIs. However while AfDB's credit rating is recognized, both DANIDA and AFD indicated that they have applied for this recognition from the BoT and waiting for response..

4.7.2 Ad hoc government policies and politics on agricultural CGSs

Almost every guarantee scheme interviewed had an anecdote about how an ad hoc government action had consequences that resulted in loan defaults. Some of the examples given included:

- The government zero rated sunflower oil imports which meant that sunflower oil produced in Tanzania lost its main market. Local sunflower farmers and processors incurred heavy losses which impacted their ability to pay off loans.
- Government banning of food crops export meant that harvests of food crops that had been financed with loans could not be sold profitably.
- Setting of floor prices for certain commodities. While this may have been well intentioned, it also made those commodities more expensive compared to other places and forced buyers to import rather than buy locally.
- There has been political interference with warehousing system which farmers use to store their produce and mitigate the volatility of produce prices. This hinders natural market forces in the trade of the commodities. PFIs are adamant that if this is allowed to happen, farmers will suffer.
- Such ad-hoc policies result in losses by farmers who then default on guaranteed loans. The reaction from CGSs has been one of extreme caution in areas where government intervention is deemed to be high. For instance, the Rabobank advisor for SAGF indicated that they avoided applying the scheme in the coffee sector which is perceived as politically sensitive with excessive government regulation.

4.7.3 Lack of an Identification System

Tanzania has no national identification system. Voter cards are the most frequently used form

of ID but political party identity cards, birth certificates, formal and informal letters are all used for identification purposes. This lack of an integrated and standardized identification system makes it hard to keep track of borrowers who have defaulted on loans. It also enables such borrowers to keep getting new loans, thereby raising the risk levels in the entire system.

The financial sector has lobbied the government to address this issue. In response the National Identification Authority has been established and has started issuing identity cards - albeit at a very slow pace.

4.7.4 Education levels

Low levels of education among the population. FSDT research shows that only 17.5% of MSME owners and only 12.5% of agribusiness owners have a higher than primary level of education. A consequence of this is that citizens do not feel knowledgeable enough to interact with the financial sector. In addition, most financial institutions communicate in English, whereas most Tanzanians are more comfortable with Kiswahili. Customers frequently claim difficulties in understanding the contents of legal documents which they may have already signed.

Financial institutions have responded to this by translating documents into Kiswahili (e.g. Bank of Africa) and also contracting with groups like SACCOS which may have educated representation, rather than dealing with individuals.

4.7.5 Infrastructure

All infrastructure - especially power infrastructure - is inadequate, unreliable and under developed. In 2008, there was a complete blackout for more than a month throughout the entire island of Zanzibar. A number of borrowers who had taken SME loans guaranteed by FSDT cited resultant losses

incurred as the main reason for defaulting on the loans. With the discovery of various energy sources including natural gas, it is expected that the infrastructure will become more reliable with time.

Poor infrastructure in Tanzania also means that guarantee schemes are unable to reach farmers and other small borrowers in remote areas. Guarantee schemes depend on financial institutions to reach their target market. However, financial institutions are often reluctant to go into remote areas because they are so badly served and difficult to reach. It is therefore very difficult for guarantee schemes to reach the populations in these areas.

The response has been to seek those financial institutions that have the broadest reach and most branches in the country. NMB and CRDB banks have significantly more branches than the other banks in the country and it therefore not surprising that both are involved multiple schemes with different guarantors.

4.7.6 Land Ownership

Land ownership problems impact the financial sector as all land is owned by the Government, held in trust by the Head of State or controlled by customary law. The Village Land Act and the Land Act, both of 1999 are the main laws governing the ownership of land. It is possible for an investor to acquire land for development on a long term lease. However there are still major problems encountered when seeking the permission of village elders to acquire land, and when trying to obtain a title deed that can be used for collateral. Recording of land into a digital system is in progress. In the meantime, the current land registry system is heavily manual, disintegrated and inefficient. This means that resolving land ownership issues can take a very long time. These difficulties in direct ownership of land impact its use as collateral and to some extent, may contribute

to the general failure to make improvements on land that is not personally owned.

This problem is closely linked to the fact that the judicial process is very slow and resolution of cases on land matters can take a very long time. Banks have responded by being very wary of accepting land as collateral unless ownership is absolutely clear. In the absence of an alternative, they will simply not issue loans.

4.7.7 Judiciary

The judicial system is very slow and commercial cases take years to resolve. Banks would rather not lend to any 'risky' borrowers than end up in court. Various lobby groups have been working with the government to overhaul the judicial system but the process is slow.

4.8 OTHER IMPEDIMENTS TO ACHIEVING CGS OBJECTIVES

Other factors that may limit the impact of guarantee schemes include:

- i) Most of the guarantors in Tanzania have chosen to authorize portfolio guarantees despite the lack of technical capacity at the PFIs. This has resulted in default rates that are higher than international standards, while viable projects continue to be overlooked. Normally, retail CGSs would be very helpful in such a situation as they work with the PFIs on each loan application helping them learn how to discriminate between good and bad projects.
- ii) Insufficient information. Most of the economic and financial information that facilitates informed decision making is unavailable. Data on important economic variables, industry data, population demographics etc. either does not exist or is not easily available. This problem was highlighted by AGF who said that they have had to develop proxy

indicators to determine probability of default. The registered credit reference bureaux are also quite new and have yet to be integrated into the system; borrower histories are still not available to lenders.

iii) According to the PFIs interviewed in this review, other areas in which CGSs could be improved are:

- More efficient payment of claims. Some schemes require the PFI to go through all recovery processes before submitting a claim. Once the claim is submitted, it

can take up to a year before it is paid. This has a negative impact on the PFIs who would like the system changed.

- The guarantors wait too long before they notify PFIs whether or not the scheme’s term will be renewed. This can mean that all activity under the scheme stops while the decision is pending thereby losing all momentum.

4.9 AREAS OF STRENGTH AND WEAKNESS FOR TANZANIAN CGSS IN MEETING OBJECTIVES

Table 4.6 Strength and weaknesses of CGSs

Strength	Weakness
Enhancement of borrower technical capacity by PASS and agro-dealer schemes reduces risk and provides long lasting benefits	Slow payment of claims which has undermined partners confidence
Partnerships with and knowledge transfer from international donor agencies such as DANIDA have benefited some PFIs	Poor selection of partner financial institutions whose goals are in synch with guarantor’s goals
Working with groups such as SACCOS and also other farmer groups has resulted in lower transaction costs	Technical capacity at both CGS and PFIs especially with regards to SME and agricultural finance
Innovative value chain approaches such as working with agro dealers to increase farm inputs have impact on multiple levels	Leverage levels are very low meaning impact is not as high

4.10 RELEVANCE AND EFFECTIVENESS OF CGSS

- According to a World Bank report (Beck et al, 2008), guarantee schemes are the most common government programmes used to support SME financing in both developed and developing countries. Guarantee schemes were also found to be the most preferred mechanism for banks ahead of other options such as directed credit programmes, interest rate subsidies and regulatory subsidies such as lower capital requirements for SME lending.

- Banks find CGSs to be convenient because unlike other tools, CGSs require minimal changes in the way the bank conducts its business. Ideally under a guarantee scheme, banks should only take on loans for projects that they would ordinarily take on except for lack of collateral. Ideally also, borrowers should not know that their loan is guaranteed and as much as possible should treat the loan as any other bank loan and work diligently to get it paid off.

The PFIs interviewed in this review expressed the following sentiments with regards to the guarantee schemes in Tanzania:

- i) NMB bank stated that while it had experienced many difficulties working with agro-dealers, the agro-dealer input scheme was quite successful in getting inputs to farmers. This had a positive impact on agricultural production.
- ii) Stanbic, NMB and CRDB banks were all of the opinion that while ECGS has had its problems, it has had a tremendously positive impact on Tanzania's agriculture.
- iii) The technical assistance offered by some schemes such as PASS to borrowers is considered to add great value and decreases the risk and amount of work that PFIs would otherwise have to handle. PASS acts as a screener of borrowers helping to weed out bad ones and make the good ones more bankable, therefore reducing default rates. In this regard, PASS is seen as the most effective scheme in terms of bringing in new borrowers into the credit system.
- iv) Before 2010, Stanbic bank only focused on corporate agricultural lending but has now started lending to small farmers. This change can be attributed mainly to Stanbic signing up as a partner in the Agricultural Credit Guarantee. In addition, the bank intends to continue working with these farmers even after the guarantee coverage ends. NMB, CRDB and other PFIs also stated their intention to continue working in the sectors that have been opened up by the CGSs even after the guarantee terms are over.
- v) Tanzania Women's Bank reported that because of it is now participating in the African Guarantee Fund, it has now increased the loan sizes it is offering to group borrowers. This is because it is now able to share the risk of lending to these groups.
- vi) All PFIs were in favour of CGSs expanding their capitalization and scope

of activities because they are the only tool that allow the PFIs to profitably reach certain segments of the population that would be otherwise considered too risky.

- Most of the PFIs interviewed were reluctant to give access to CGS loan beneficiaries on the grounds that if the beneficiaries became aware of the guaranteed nature of their loans, it might create an incentive to default. Some of the PFIs were also cautious due to concerns about customer confidentiality. However, a few case studies were obtained that give an insight into the impact made by the credit on farmers' lives.

4.11 VIEWS FROM OTHER CGS STAKEHOLDERS

4.11.1 Ministry of Industry and Trade

While CGSs continue to have a positive impact on the Tanzanian economy, there remains a significant gap in the flow of credit. For example, FIs are still reluctant to work with micro enterprises.

- The ministry operates the National Entrepreneurship Development Fund managed by SIDO which provides loans directly to micro entrepreneurs ranging between Tsh50,000 and Tsh2.5 million.
- The ministry has been working with various SMEs, youth and women groups to form an umbrella association that can lobby government more effectively.
- Government also has a youth development and women's fund.
- The ministry feels that these funds should co-exist with CGS since they target sectors including micro-borrowers, which are not served by CGSs effectively.

4.11.2 Ministry of Finance

The ministry also pointed out challenges faced by its GSs including:

- The Export Credit Guarantee Scheme was hit hard by the 2008/09 economic crisis and experienced a high number of defaults. The scheme is still struggling to recover and explains why there have been so many complaints of slow payment.
- There is a serious need for technical assistance to SMEs especially in the preparation of business plans. This would help banks to appraise them more effectively.
- The SME Credit Guarantee Scheme was poorly structured causing a lot of defaults and eventual suspension. These issues have been addressed and the scheme is expected to begin again in the near future..
- Moral hazard continues to be a considerable challenge due to the national and international political situation.

The ministry confirmed that the government CGSs will soon be moved away from the BoT to a new, independent entity.

4.12 DISCUSSION POINTS FOR STAKEHOLDERS IN TANZANIAN CGSS

4.12.1 Are there too many guarantee schemes and do they impact each other negatively?

This question was posed to both guarantors and PFIs. Almost all agreed that there remains a huge, unfulfilled demand for credit from SMEs and agriculture, suggesting demand is outstripping supply. However, the lack of uniformity among CGSs posed some challenges:

- Fee structure: guarantee companies such as PASS and AGF are seeking long-term sustainability and therefore have relatively higher annual fees . This is in addition to

other one time fees which it is felt, represent the actual cost of services. On the other hand, most donor funded programmes have very low, or no fees (the range is 0 to 2.5%). This becomes a problem for the commercially oriented companies which use the low fee structure offered by the GSs as a bargaining chip when dealing with PFIs.

- Claim payment processes: some GSs that may want to go through the whole loan recovery process before paying a claim will find themselves undercut by those that are willing to pay upon submission of a claim.
- Varied reporting requirements by each GS can be viewed as a burden to PFIs. Guarantors have unique reporting requirements. Some only need two reports a year, while others need them every month or on an ad hoc basis. Similarly, although there is great variation in formats and templates, most of the subject matter is very similar. Finally, some guarantors will provide friendly online templates which ease reporting while others do not.
- There were also suggestions of market distortions caused by GSs that come into the market for a brief tenure with features that cannot be sustained. These include very low interest rates on loans and no fees charged to PFIs.

4.12.2 Government regulation of CGSs

- At the moment, CGSs in Tanzania are not regulated and are not required to register with the government unless they are incorporated. A number of PFIs suggested that there was a need for a regulator who could enforce claim payments by guarantors and also streamline guarantor reporting requirements. Guarantors on the other hand, felt that a regulator had no significant role to play and would only impose unnecessary bureaucracies. Either way, this is an issue that deserves further discussion. A regulatory or coordinating

entity has the potential to create awareness among guarantors of each other's activities so that they are not working at cross purposes. Guarantor reporting requirements need to be standardized so that PFIs are less burdened.

4.12.3 BoT as administrator of the government's credit guarantee schemes

There is a strong sentiment among FIs participating in the government's Export Credit scheme that the BoT should not be the administrator of the government's schemes. The argument is that as the main regulator of the banking sector, the BoT has a conflict of interest; its role should be to monitor the liquidity and risk levels of Tanzanian banks to ensure that they remain adequately capitalized and not financially at risk. However, in its role as a guarantor, the BoT tries to maintain its schemes' capital by managing claims submitted by PFIs. The BoT will therefore reject many claims by PFIs, insisting that they restructure the loans instead. The BoT is also quite slow in paying approved claims. The PFIs have no means of compelling it to pay their claims, and in consequence end up carrying these non-performing loans on their books for long periods. In addition, there is no independent body to verify that the government schemes are adequately capitalized.

Fortunately, following a review of the government schemes, a recommendation was made that all government schemes should be moved away from the BoT to an independent body. The government has accepted this recommendation though details and exact dates of the change remain unknown.

4.12.4 Technical assistance/capacity building

There is an immense need for technical assistance for SMEs and farmers. Most of the

interviewed banks and guarantors talked of a 'lack of business skills', or 'low financial literacy' to describe this phenomenon. PASS has been very involved in helping borrowers to prepare loan applications and develop business plans. PFIs involved in PASS have all indicated that these activities greatly enhance the bankability of borrowers who also benefit by developing a better understanding of their business. Other similarly positive initiatives include the agro-dealers credit guarantee scheme which makes it a pre-requisite for agro-dealers to get business skills training before they are able to apply for credit. Banks such as NMB also has an Emerging Farmers Programme which selects a few candidates who show potential, and over a three year period, provides them with the technical training and financial literacy necessary to develop the necessary commercial skills.

4.12.5 Questionable elimination of risk by PFIs

CGSs are risk sharing tools which when used properly enable FIs to engage with borrowers they would otherwise consider too risky. As long as both parties share the risk equitably, the system will work to ensure that moral hazard is avoided. However, with the use of co-guarantees, banks can significantly reduce their risk. For instance, a bank can get two guarantors to give 50% coverage of the same loan thereby eliminating all risk. While no evidence of this was discovered, quite a few guarantors explicitly allow the PFIs to get co-guarantors as long as the total guaranteed portion of the loan does not exceed 75%. While this may not be unreasonable, banks will also get some form of collateral from borrowers, further reducing their risk. This may be good for the bank but also opens up the potential for them to approve much riskier loans. It also means that some borrowers who cannot come up with collateral may not be approved, even

though the presence of a guarantee is designed to prevent this eventuality.

4.12.6 Credit Reference Bureaux

As already mentioned, the Tanzanian Financial Sector is challenged by asymmetric information as well as a persistently high rate of loan defaults. The implementation of credit reference bureaux has been shown to mitigate these problems in other countries. Similar results can be achieved in Tanzania. In 2012, the BoT launched the Credit Reference System (CRS) which will collect credit histories from all banks as well as credit bureaux. The BoT has also licensed three credit reference bureaux to operate in Tanzania.

These are Creditinfo Tanzania, a subsidiary of Creditinfo Group of Iceland which was licensed in 2012, Dun & Bradstreet Credit Bureau Tanzania Limited, licensed in 2013 and Transunion. The newness of these bureaux combined with the fact that most Tanzanians do not understand their role means that it will be a while before the impact of these bureaux can be felt in the market. However, without CRBs, the efforts of CGSs to introduce new participants into the credit market will be wasted: the information about the history of these new participants will either be lost or continue to be held in dispersed data repositories that cannot be accessed by all credit providers. Borrowers should be able to apply for credit at any bank on the strength of their credit history.

5.0 Lessons Learnt

The processing and payment of claims submitted by PFIs is arguably the greatest determinant of a scheme's impact and sustainability. The case-studies at the end of this report repeatedly show that PFIs will get increasingly frustrated by the slow processing of claims and will be reluctant to process new loans as a result, undermining the impact of the scheme. In Tanzania, the best example of this is the Export Credit Guarantee Scheme. Initially, PASS also had the same problems and had to reinvent itself to regain the confidence of its PFIs.

The lack of payment or changing of rules after claims have already been submitted will destroy the credibility of the scheme. On the other hand, the solvency of a CGS is at stake if too many claims are paid. The only way to reconcile these two issues is by thinking through, negotiating and documenting mutually acceptable claim payment rules before partnerships with financial institutions are implemented.

All parties involved should bear some risk. As already mentioned, moral hazard is always an issue when one party reduces or eliminates the risk carried by the other. It is therefore critical that both the PFI and borrower maintain some 'skin in the game' to ensure that each party is aware of and takes measures to prevent potential losses in the event of a default. The borrower should give some form of collateral (even if it is not of the kind traditionally accepted by banks) e.g. signing a lien on livestock in exchange for a loan for purchasing farm inputs. Likewise, the guarantor should ensure that the PFI carries a portion of the loan not covered by guarantees or collateral. A consequence of this lesson is that very few - if any - guarantors accept first loss guarantees. These are when the guarantor pays out on all the initial losses up to a specified limit, before other participants start sharing in the losses.

Instead, all losses are now shared 'pari passu' meaning that both share in the final loss.

Technical knowledge is essential. It is no longer sufficient for guarantors to put up guarantee capital and trust that PFIs will take care of the rest of the details. This is especially true in Tanzania and other developing countries where FIs have yet to develop the sophisticated technical capacity necessary for agricultural and SME financing. CGSs should be proficient in credit analysis, risk management, portfolio and treasury management in order to supplement and help improve the capacity of the PFIs. Technical knowledge in agriculture and agricultural finance is also essential. SAGF attributes its success in agriculture to its expertise in these areas.

Agricultural credit guarantee schemes should expect higher loss rates than SME schemes because there are more variables in agricultural finance that cannot be controlled. This is especially true in East Africa where most agriculture is greatly influenced by weather patterns, farming is on a small scale and prices of produce are volatile and beyond local control. Agriculture also tends to be a politically charged issue and as such, government policies such as the banning of imports or exports of a particular product

can also result in losses which hurt both the guarantor and borrower.

Size matters. Large GSs such as those funded by USAID-DCA and DANIDA are usually favoured by FIs as they allow them to expand their operations significantly. Smaller schemes are often seen as not worth the effort, especially if not from the same donors who fund the larger GSs.. It can be difficult for small schemes to achieve economies of scale or be self-sustaining. In general, the Tanzanian FIs interviewed in this review considered schemes of less than USD\$ 1million to be small. Although a smaller FI might be willing to work with a small CGS, it may also find its technical capacity is insufficient to achieve the CGS objectives. Credit Reference Bureaux: the potential long term benefits of CGSs will be completely lost if all the new borrowers brought into the credit system are unable to build a good credit history.. By building credit information databases, CRBs also help to reduce the information asymmetry that contributes to an increased perception of risk and subsequent high interest rates. Most of the CGSs covered in this report operating outside Tanzania have either created, or work very closely with CRBs.

Publicity: it is generally a good idea to avoid publicity of the guarantee scheme especially if it cannot be controlled. This is a problem especially for schemes in which the government is involved, such as ECGS and Kilimo Biashara in Kenya. Politicians tend to propagate inaccurate information and suggest that their constituents can get 'free loans'. However, publicity can be used to good effect to create awareness of the scheme, particularly if it is made clear that there is no free money and all lending procedures are to be followed.

Grouping of farmers (as cooperatives, associations or out-grower groups) helps to reduce transaction costs for PFIs. Another

benefit especially applicable to Tanzania is that financial institutions do not have to contract with each individual farmer who may have difficulties understanding the contract. Instead, the more knowledgeable group representatives can communicate with the financial institutions on behalf of members. Group dynamics can also be leveraged: peer pressure by group members helps to keep defaults low. Ultimately, groups enhance bargaining power for farmers while helping to realize economies of scale. PASS has been particularly successful in this area.

Guarantees do not make bad projects more bankable, nor do they make bad banks better. It is therefore critical that the only loans guaranteed are for projects that are otherwise viable except that they are not considered 'bankable'. Similarly, guarantors should not simply hand over funds to arbitrarily selected banks and expect them to achieve the set objectives. There should always be excellent due diligence, not just concerning borrowers but also banks.

The impact of guarantee schemes is significantly constrained by macro variables that may be beyond the control of the scheme. These variables include the effectiveness of the country's judicial system, the financial regulatory system and the entrepreneurial capacity of the population in question. Tanzania's inefficient judicial system makes financial institutions wary of entering into lending contracts that may have to be resolved in courts. Financial institutions are much quicker to submit claims on loan defaults than try to recover the loans in cases where guarantees are used to cover loans,. Tanzania's lack of recognition of first class banks as guarantors also hinders the scope of some guarantee schemes.

6.0 The best practice CGS

The following sections offer some best practices from Tanzania and around the world on the creation, implementation and administration of CGSs.

6.1 SETTING UP

A credit guarantee scheme is a major undertaking which if implemented in the right way, can have a significant impact on individuals, institutions and even markets. It is therefore imperative that the potential guarantor invest some time, effort and resources in making sure that the GS is correctly set up. The German Federal Ministry for Economic Cooperation and Development proposes the following four steps to set up a guarantee scheme (BMZ, 2012):

- i) Have an exploratory phase in which information is gathered on various aspects of the envisioned guarantee scheme. This may involve discussions with potential co-guarantors as well as conducting market research to determine the size of the market i.e. number of SMEs, farmers etc., the obstacles they face in getting credit, the FIs operating in the market etc.
- ii) Using the findings of the first phase, various options are evaluated and an optimal design of the GS, which factors in all known information as well as the guarantors' objectives, is documented.
- iii) A pilot model of the GS based on the results of the second phase is created and tested on a group of stakeholders or GS experts. Adjustments are made based on the feedback received.
- iv) The GS is registered and incorporated with its own articles of association, partnership

agreements between co-guarantors and resources including employees and a budget.

6.2 SOME STRUCTURAL DESIGN AND IMPLEMENTATION CONSIDERATIONS

- CGSs should be run as independent entities rather than programmes of a donor agency for reasons already stated. Current trends indicate that incorporation is the best approach for a CGS. If funded by the government, the CGS should be created by a statute that guarantees independence from political influence. The company can have a board comprised of the entities providing funds as well as other stakeholders such as representatives of the government, SMEs and farmer organization (see example of FEGA in Mexico-Annex 1).
- If the guarantor would rather run the CGS as a programme, then it should be headed by a committee or other body specially formed for that purpose and staffed with technically competent personnel. This body should meet frequently (once a month is recommended) to review progress made by the PFIs and advise on any adjustments required.
- Fees: each CGS should have at least a risk sharing and an appraisal fee. The latter should be structured to cover the cost of the scheme's administrative and due diligence efforts while the former should compensate for accurately measured risk associated with the PFI and loans. Risk sharing fees should be on outstanding loan amounts while appraisal

fees should be on the principal amount. A third fee that should be considered is the commitment fee charged by AGF to the PFIs that do not originate loans at the agreed upon rate. The rationale here is that the PFI is tying down AGF's capital which could be used elsewhere. The PFI has to reimburse AGF for that opportunity cost. By enforcing this, PFIs are incentivized to originate more loans.

- Coverage ratios can be used by CGSs as a tool to direct lending to various target markets. In some cases, DANIDA's SME and microfinance scheme incentivizes CRDB to lend to businesses led by women by offering 80% coverage (rather than the flat 50% coverage for all borrowers). Coverage ratios can also be reduced in sectors where the CGS feels it has more exposure. For example, if PFIs have lent too much in one geographical area, the coverage ratio in that area can be substantially reduce. This will be a signal to PFIs to start lending elsewhere.
- Eligibility: regardless of which borrowers are targeted, it is advisable that financial institutions first process all loan applications and only then forward to the CGS those that would have been approved except for lack of collateral.
- Interest rates should not be significantly lower than market rates as that usually means there is a subsidy which is not sustainable in the long run. A better practice is to start off borrowers at near market rates and then reward them with periodic interest rebates or reductions in rates for servicing their loans. For instance, a borrower who starts at 15% could get a point off their rate every year if their account is in good standing. This practice is currently being implemented to good effect by Nigeria's Agricultural Credit Guarantee Scheme Fund.
- While guarantees on loans usually last until the loan has been fully paid off, the first instalment clause as used by Lithuanian CGS Invega, should be considered a best practice.

The CGS takes the first risk for non-payment of the loan meaning for instance that if it has offered 50% coverage ratio on a loan, instead of being liable for half the outstanding amount for the full term of the loan, it is only liable until the first half of the loan has been paid. This means that the fund is able to get out of guaranteed loans in less time so that it can free up capital to guarantee more loans.

- Collateral should be based only on the unguaranteed portion of the loan rather than the whole principal. This makes it easier for the borrowers to share in the risk without it being too burdensome.
- Leverage: leverage can be enhanced by having a significant proportion of the guaranteed loans portfolio going to short term lending which has a higher turnover. Also, signed commitments or guarantees on paper allow for greater leverage. It should be noted that a leverage which is too high leaves the CGS vulnerable to defaulting in the event that too many claims are submitted, e.g. if there is an economic crisis or in the case of an agricultural CGS, in the event of crop failure.
- The CGS should go beyond the traditional guarantees for SMEs and agriculture and innovate according to market demand. This includes equity and leasing guarantees etc. PASS and AGF are Tanzania's market leaders in this respect.
- The CGS should also invest its capital with a competent fund manager as treasury management is also critical in ensuring that a CGS is earning enough income off its capital to supplement its fee income.

6.3 PARTNER SELECTION

The selection of the right financial institutions to participate in a guarantee scheme is critical to the success of the scheme. Some of the schemes covered in this report including PASS and the agro-dealer scheme had a negative

impact as a result of partnering with financial institutions that were not suited for the scheme. The following are some factors cited by guarantors as being part of their due diligence when selecting partners:

- Experience in working with SMEs, agriculture or any other sector in which the guarantor may be interested. The difference between those that continue to succeed and those that have failed is directly correlated to the bank's previous experience in working with small agricultural enterprises. In the absence of such experience, it is important that the bank at least show an interest in working in that sector. This interest may be established if for instance, the bank approaches the guarantor rather than the other way around. This interest should also be verified to come from the bank's top management and other crucial stakeholders. Where the bank has limited experience, it is recommended to start as a retail guarantee before authorizing a portfolio guarantee. In this way, the guarantor can monitor the partner's progress and participate in building their capacity to appraise loans.
- Evaluation of a potential partner's credit risk including as assessment of credit processes. African Guarantee Fund uses a sophisticated process to determine which partners to work with. First, it ranks all the financial institutions in a country based on information received from regulatory authorities. AGF uses an 8 tier ranking system and will only work with banks in the top four. If a bank wants to work with AGF, it is required to submit a detailed application in which it describes its loan origination, appraisal, monitoring and recovery processes. This information is fed into a risk scoring model which then determines into which tier the financial institution falls. The associated risk. banks in the top tier are considered the least risky and as such, are charged lower fees than those in lower tiers.
- Financial position, shareholding and political risk evaluation e.g. ARIZ's due diligence

of potential partner FIs entails an analysis of their financial position, not only to get a sense of how strong the FI is, but also where its resources are focused. As part of assessing the FIs financial position, the CGS will also be interested in assessing the FIs non-performing loans portfolio. ARIZ is also interested in knowing who the main shareholders of the bank are, and their influence within the bank. This helps to determine if there is any likely political influence.

- Compliance with anti-money laundering regulations and negative political exposure are concerns. Negative political exposure here refers to the FI being associated with a person or persons in government or politically connected to it, who may influence the bank's policies and activities. This is a key requirement for ARIZ and AGF.
- Geographical coverage: the big banks with the most branches across Tanzania had the lion's share of guarantee schemes. However, if a CGS is interested in working with entrepreneurs in a specific location, it is better to work with an FI with an established presence and local knowledge rather than looking for the biggest bank.

The term 'partner selection' has been used in this report to mean choosing the right PFIs; it could also be used to refer to co-guarantors. There have been instances where two or more guarantors have partnered up only to realize that their objectives and expectations are not aligned. It is critical that even at the co-guarantor level, comprehensive discussions are held before starting the scheme. If possible, the results of these discussions should be documented in an agreement separate from that signed with PFIs.

6.4 GUARANTEE FRAMEWORK AGREEMENT

Once a partner has been identified and has undergone a successful due diligence

assessment, the two parties should embark on discussions which culminate in signing a comprehensive agreement. At the very least this should cover:

- Governance and decision making process: the top decision making body of the CGS should be clearly identified. Ideally, all stakeholders in the scheme including the PFIs should be represented in this body.
- Roles of each partner – the contract should be explicit about what is expected of each partner.
- Description of the guarantee process – it is important to clarify the process involved from when an application is received to when the loan gets covered by the guarantee. This applies both for retail and portfolio schemes.
- Eligibility – be specific about the type of enterprises and products that are to be covered and, even more importantly, those which are not. Most schemes in Tanzania that target agriculture do not support tobacco farming or any ventures involved in production of alcohol. In the agro-dealer credit guarantee scheme in Tanzania, only those agro-dealers that had undergone a specific training programme were eligible for loans.
- Coverage ratio. Most schemes in Tanzania use a flat coverage ratio for all loans (usually 50%). But the CGS can and should use different rates based on a variety of factors including risk, target population, portfolio or retail guarantee etc.
- Duration of protection, grace period and renewal provisions. The tenure of the guarantee scheme is an important factor as is its renewal. The Agricultural Credit Fund (ACF) has a term of 5 years, with the last 2 years being a grace period during which new loans are not issued. PFIs also emphasized the need for the guarantor to let them know as early as possible whether the scheme will be renewed.
- Maximum and minimum loan amounts and interest rates. Some donor funded CGSs such as in the AGRA/Equity bank agro-dealer scheme specified actual interest rates of between 10 % to 15%. However, it is preferable to quote a rate that is a function of an established major rate, for example the rate offered by the country's central bank.
- It should be made clear that only new loans starting on a specific date are eligible for cover. In addition, the guarantor reserves the right to review and approve or deny cover for any loan submitted by a PFI. This will go a long way in preventing adverse selection. This refers to the risk that banks will pick out their non-performing (or potentially non-performing) loans to be covered by the CGS so that the bank can claim compensation when default occurs.
- Fees – specify the types of fees charged, the rate, whether charged on the principal, outstanding amount and whether payable by the borrower or PFI.
- Reporting requirements, targets and performance indicators that will be used to gauge the success of the scheme.
- Default trigger event, claim processing and loan recovery processes. This tends to be a controversial issue and therefore requires the utmost clarity. The parties should agree on when a claim should be submitted, the time taken to process and pay the claim, and what the expectations are regarding loan restructuring or recovery. For instance, does the FI have to file a court case or are recovery efforts considered over after a certain period.
- The agreement should also be clear about the nature of the approval, monitoring and recovery documentation to be kept and submitted by the PFI.

Ultimately, what is important is that both partners should honour the agreements. It is acceptable to renegotiate based on market

realities but confidence can be shaken or destroyed, especially if the guarantor waits until claims come in to start changing the details of the agreement.

6.5 CLAIMS PROCESSING

Claims management is also an essential feature of a sustainable GS. The guarantor has to balance the need to minimize claims payments with the importance of maintaining the confidence of PFIs by paying promptly. Based on the GSs studied in this review, the best practice seems to be to pay a portion of the claim amount as soon as the claim is submitted. Subsequently the PFI will be required to go through all recovery measures before the final realized loss can be paid. Other claim management measures include:

- Pay promptly as per guarantee framework agreement to keep confidence and cooperation of PFIs but adjust fees upwards for PFIs that have too many defaults. Downward fees adjustments can also be made for PFIs that have reduced claims as a reward/incentive for good performance.
- Conduct - basic due diligence on all approved loans must be carried out before funding is awarded in order to ensure that all lending is in compliance with the eligibility, amount limits and tenures as specified in the agreement with the PFI. This should happen even in cases where the PFI has a portfolio guarantee. There should also be regular audits of PFIs to ensure that loan monitoring and recovery processes are being followed.
- Ensuring that coverage ratios and fees are in line with the risk associated with specific loan portfolios. This ensures that claims which are expected can be reasonably forecast and provision can be made for them.

6.6 ON-GOING RELATIONSHIP WITH PFIS

There should be a real partnership between guarantors and PFIs with both seeking to maximize the impact of the GS. Guarantors should therefore be ready to listen to feedback from PFIs and offer them the necessary support. PFIs on the other hand, should ensure that defaults are kept to a minimum by appraising and monitoring loans diligently and seeing through all recovery efforts when a default occurs. Other collaborative measures include:

- Sharing of information. Regular discussions between CGSs and PFIs in which information is exchanged on the performance of guaranteed loans portfolio, and prospective new loans are useful. In this way, the PFIs get a sense of the risk levels in the market and how they are being viewed and priced by others. KODIT of Korea has built an online marketplace for loans targeted at reducing information asymmetry. This is achieved by allowing borrowers and lenders to congregate together in one place and exchange information on the best loan terms sought and made available.
- Reduce the reporting burden on PFIs. In Tanzania, most GSs seem to have settled on having quarterly reporting, semi-annual field visits by guarantor to borrowers, and annual full audits. PFIs reporting can also be made easier through use of technology. USAID-DCA for example, uses online templates to which attachment of existing reports can be made and any additional data entered. The PFIs have reported great satisfaction with these templates. The reporting burden can also be reduced by using reports that the PFI is already generating for regulatory or internal reporting purposes, and giving them a template for any necessary additional information.
- When a guarantor denies coverage of a particular loan, the guarantor should

communicate the reasons. Over time, the PFI can then adapt either by improving its appraisal processes or educating borrowers about how to improve their prospects.

- Support the PFIs with technical assistance/ capacity enhancement where they are weak. GSs have and should continue to invest in developing the capacity of banks to appraise SME and agriculture loans by bringing in experts.

6.7 BEST PRACTICES FOR AGRICULTURAL CGSS

Agricultural financing has its own, unique challenges compared to SME and other financing. Over time, CGSSs specializing in agriculture have developed some responses to deal with these challenges. These include:

- Diversifying the guaranteed loan portfolio by increasing the range of agricultural products covered by the scheme. If there are losses in one product, they can be offset by other products.
- Obtain weather-based index insurance to mitigate losses due to weather related events such as droughts and floods. Stanbic Bank reported that the product has been helpful in minimizing their losses under the SAGF scheme.
- Adopt a whole value chain approach. ACG has achieved this not just by financing farmers but also other actors up the value chain such as processors, traders and exporters. By doing so, they improve the farmers chances of selling their produce and ultimately being able to pay off their loans.
- Invest in specialized agricultural knowledge and expertise to guide the CGSSs investment decisions. Rabobank attributes the low default rate that the Sustainable Agriculture Fund has had to the high level of technical expertise in agriculture it enjoys. The bank has an agricultural finance analyst working at NMB who advises them on new areas that the Rabobank guarantee scheme can expand into, as well as the best structure for financing specific agricultural produce.
- Work with warehousing systems where farmers can store their harvested crops until prices in the market are favourable. Warehouse receipts should be embraced as collateral. Stanbic Bank and the Agricultural Credit Guarantee are doing this to good effect in Tanzania.
- Work with a FI that either has or is ready to set up an agricultural financing department or desk. Both NMB and CRDB pointed out that agricultural finance cannot be successfully implemented under SME banking because of its numerous unique challenges.
- For smaller borrowers new to the credit system, the PFI should require proceeds from sale of produce to be channelled through the bank. Loan funds can also be directed where they are needed. For example, in the case AGRA funded agro-dealer scheme, cashier's checks were made out directly to input suppliers instead of borrowers withdrawing cash, which could be easily misappropriated.

7.0 Conclusion

There is reason to hope that the Tanzania’s leadership will continue to focus on implementing practices, policies and institutions that will move the country to a middle income status over the next two decades. This prediction is based on the economic growth rates the country has been experiencing over the last five to ten years. However, the results so far also indicate that the benefits of this growth are not yet trickling down to most of the population, including those engaged in farming and other small business enterprises.

Credit guarantee schemes have become popular all over the world. Granting access to credit to sectors which banks have traditionally been wary of, they have been used to great effect, particularly in the agricultural industry and SMEs. Some of the benefits which can be attributed to CGSs include:

- Helping to address economic crises such as those in Asia in the 1990s (e.g. Korea’s KODIT) and more recently in Europe (UK’s Enterprise Finance Guarantee). In such climates when banks become too cautious to lend, governments step in to guarantee loans to SMEs. This gives the economy an opportunity to keep growing through private enterprise.
- CGSs can help incentivise value chain suppliers to supply credit. (Beggs, 2010)
- FIs benefit from participating in CGSs by acquiring knowledge of new sectors while sharing the risk. CGSs work closely with PFIs to improve their technical capacity. This can be achieved by offering training and constructive feedback in cases where a CGS has better qualified staff.
- CGSs increase competition among banks by opening up new sectors and channels in which they can participate. Eventually, big banks that focus on corporate lending may

find themselves at a disadvantage as smaller, more responsive banks focus on SMEs.

- CGSs also address problems associated with income and wealth inequality. In a traditional banking system, only those with collateral can access credit facilities. CGSs clear this obstacle allowing those at a disadvantage to access credit with which to improve their business/standard of living.

In Tanzania, many farmers and small entrepreneurs have experienced a positive impact through CG schemes, and not just by gaining access to credit which allows them to improve their livelihoods. Schemes such as PASS have provided valuable business planning and financial literacy services, while the agro-dealer scheme helped farmers gain access to quality inputs for their farms. Other schemes such as AGF are pooling the resources of multiple bilateral and multilateral partners. When combined with a high level of technical capacity, this can be expected to achieve significant impact both in Tanzania and throughout Africa.

Some of the CGSs reviewed in this report, and especially those outside Tanzania have been in existence for more than 10 years and have

undergone serious challenges while adapting to their markets. However, over time, they have made adjustments and gone on to make significant impacts on their economies. Perhaps the best examples have been in Europe and Asia where CGSs have been used to mitigate the effects of economic crises, and in some cases to jump start stalled economies.

This report documents the lessons learned and best practices gathered from schemes in Tanzania and other countries around the world. The FSDT hopes that it will be used as a resource to help Tanzanian CGSs, their partner financial institutions, the government and other stakeholders to surmount the challenges posed by operating in a developing country.

The experience of others has shown that well established credit guarantee schemes can have a significant, positive impact on improving livelihoods and reducing poverty in the most disadvantaged sections of society.

8.0 Recommendations

- i) There is need for harmonization of the activities of the various schemes in Tanzania to maximize their impact. All stakeholders including borrower groups, guarantors, financial institutions and the government should come together to form a supervisory and coordinating body. This will act as a registry for Tanzanian guarantee schemes, facilitating greater awareness of each CGS's objectives and activities and allowing more coordination and less undermining of each other's efforts. These stakeholders should be fully represented in the governing organs of this entity. This body would also have supervisory powers that enable it to verify the solvency of guarantors, limit market distorting activities and resolve claim disputes between guarantors and PFIs.
- ii) The government should support CGSs and the financial sector in general by making the judicial system more efficient. This may mean more commercial courts to reduce the time it takes to resolve commercial disputes, or the establishment of alternative dispute resolution mechanisms. The government should also make it easier for individuals and corporations to own land and use it as collateral in order to access the necessary finance needed to develop the land. Finally, the government also needs to address the issue of identification. As long as there is no way to identify each unique borrower and attach a credit history to them that can be accessed by all FIs, the cost of credit will continue to be high (FIs experience high default rates on loans to borrowers with a record of defaults).
- iii) The BoT and the newly registered credit reference bureaux should work together to ensure faster integration of all credit reference bureaux into the financial sector. This will create enduring financial sector deepening by ensuring that new borrowers are constantly brought into the credit system through credit histories accessible by all financial institutions. In order to achieve this, the requirement that all financial institutions submit credit data needs to be enforced. The infrastructure allowing access to the comprehensive credit databases, and training in the use of new credit processes that take advantage of this data, should also be provided.
- iv) The BoT should review applications for first class bank status recognition to allow the affected guarantors to realize the full impact possible for their schemes.
- v) Guarantors and banks should conduct regular reviews to ensure that the CGSs are actually bringing new borrowers into the credit system. Guaranteed loans should only go to good borrowers and projects that cannot access credit due to collateral requirements or lack of a credit history. Added value can be achieved if the guarantor takes time to audit a sample of the borrowers to ensure that they were indeed not bankable.
- vi) Guarantors in collaboration with participating financial institutions should conduct regular monitoring and evaluation assessments, to determine if scheme objectives and target populations are being effectively reached.

- vii) Banks need to embrace a new perspective in evaluating and appraising credit applications from small borrowers and MSMEs. There is currently too much emphasis on collateral based lending. Adopting methods that place a greater focus on determining project viability and risk would lead the banks to discover projects worth funding that they are currently overlooking.
- viii) PFIs should also not be too quick to declare defaults on loans if the restructuring is possible. Currently, banks are keen to claim reimbursement from guarantors. If there was no guarantee, they would be forced to work with borrowers to try and stave off a default and the accompanying loss. Helping new borrowers avoid default is good for all parties in the long term; PFIs and guarantors should work together to achieve this.
- ix) Guarantors thinking of starting small CGSs should consider partnering with established, successful credit guarantee companies. Systems, expertise and acquired knowledge can be leveraged while duplicating efforts and reducing the funds available to borrowers can be avoided. Alternatively, multiple co-guarantors should come together to form larger CGSs that can harness economies of scale. If this is not feasible, then the guarantor can partner with a smaller FI that values the increased business from using the scheme. This may entail investing in the small FIs technical capacity in SME and agricultural finance.
- x) Guarantors should continue to invest in technical capacity for both borrowers and financial institutions. They should also work to develop closer relationships with PFIs aimed at increasing financial deepening. This can be achieved by developing and sharing valuable macro level information, for example risk levels in the market and lessons learnt.
- xi) Guarantors currently active in Tanzania should further capitalize their schemes. The demand for credit in Tanzania's MSME and agricultural sectors is well in excess of the funds available at the existing CGSs at present.
- xii) The financial sector should come together to develop effective means of lobbying the government to deflect policies that could adversely impact the sector.

Annexes

ANNEX 1: GUARANTEE SCHEMES OUTSIDE TANZANIA

A1.1 Kilimo Biashara, Kenya

Background

AGRA in partnership with IFAD entered into an agreement in 2008 with Equity Bank to set up a loan scheme to primarily benefit small scale farmers in Kenya. This agribusiness scheme named Kilimo Biashara was made possible by the provision of risk sharing facilities by AGRA and IFAD in the amount of US\$ 5 million to enable the Bank to lend US\$ 50 million over a three-year period. The ultimate objective was to increase productivity and small holder farmer income.

Structure

- i) Coverage ratio is 10%
- ii) Collateral required when deemed necessary by bank.
- iii) Loan purpose for purchase of inputs like seeds, fertilizer or chemicals
- iv) Had different products targeted at different segments. These included the small scale product for loans less than Kshs. 100,000 with maximum terms of 1 year, the large scale product for loans of more than Kshs. 100,000 and terms of up to 3 years and an agribusiness product.
- v) Different interest rates for each product. 10% for the small scale, 15% for the large scale etc.
- vi) Borrowers required to have bank accounts at Equity bank where loan funds would be deposited. No cash withdrawal

was allowed and payments to input suppliers were made by bankers check.

Performance

- i) Initial guarantee fund amount was US\$2.5 million
- ii) As at May 2011, the programme had reached a total of 45,408 beneficiaries and had disbursed US\$ 26,308,264, which is US\$ 1,308,264 above the stipulated lending target of US\$ 25 million as spelled out in the loan agreement (10 times leverage)
- iii) Government of Kenya subsequently added another US\$2.5 million to encourage continued lending.
- iv) Because of government involvement, Equity Bank struggled with public perception that there was free government money available even though the bank was taking 90% of the risk.
- v) The bank has been able to reach previously unbanked customers e.g. the Bura irrigation scheme (rice) has been revived after 20 years of dormancy due to credit facilities afforded to eligible beneficiaries by the bank.
- vi) Lending in crop value chains has increased where previously lending was limited e.g. maize, rice and sorghum farmers.
- vii) Equity Group Foundation has implemented free financial literacy classes (classes on budgeting, record keeping etc.) which has helped some farmers to start adopt a more businesslike orientation to their farming ventures. Farmers also received two weeks training from agricultural loan officers on the importance of complying with the conditions of the loan scheme.

- viii) Losses over the three year term were approximately 5%.
- ix) The bank hired over 100 new staff members to deal with the demand for loans under this scheme

Summary/Best Practice

The Kilimo Biashara guarantee scheme illustrates the importance of selecting the right PFIs. Equity bank was already thinking of expanding into agricultural lending and this scheme allowed it to achieve this goal with mitigated risk. The bank also had an expansive reach and was therefore able to reach many borrowers and achieve a very high level of leverage on the guarantee funds. The bank also put controls in place to ensure minimized defaults e.g. not allowing the cash withdrawal of funds.

Another lesson is the importance of ensuring that there are no negative messages from any partner that may contribute to the scheme's failure. Political interference by sending out messages of 'free money' posed a huge challenge to Equity bank.

A1.2 Agricultural Credit Guarantee Scheme Fund (ACGSF), Nigeria

Background

The fund was started in 1978 and is co-owned by the Federal Government of Nigeria and the Central Bank of Nigeria. Its main objectives are to accelerate the flow of institutional credit to small scale farmers, provide guarantees on loans for agricultural production and processing granted by deposit money banks and to cultivate the habit of banking among farmers.

Structure

- i) Covers the production of all crops, fish farming, animal husbandry, purchase and hire of farm machinery and

integrated agricultural projects involving both production and processing.

- ii) Governed by a board whose members are chosen by the government and supervised by the Central Bank.
- iii) Offers 75% coverage ratio on principal plus interest.
- iv) Guarantees lending to both individuals and groups and has an initiative to encourage formation of self-help groups that can save for six months and then become eligible to borrow.
- v) To mitigate effects of high interest rates on borrowers, the fund offers an interest drawback programme whereby borrowers who make loan payments in a timely fashion earn a rebate. This rebate amounts to 40% of the interest paid if the loan has been properly serviced.
- vi) Also offers a trust fund model that encourages local governments to set aside funds that can be used as partial guarantee funds. Such funds guarantee 25% of agricultural loans, while the borrower provides 25% collateral. 75% of the remaining loan balance is covered by the guarantee with the bank taking on the remaining risk.

Performance

Since inception, the fund has guaranteed more than 600,000 loans amounting to \$229 million. Most of the loans went to food crops. Studies have shown that the fund has had a positive impact on the income of rural populations as well as increased employment and even nutrition. The fund experiences defaults on more than 30% of the loans that it guarantees and in 2009, this represented almost 50% of the total guaranteed loans amount. The PFIs have also complained that the fund is slow in paying claims especially claims for rebates on interest which can take up to 3 years to get paid. This has undermined confidence in the fund and has resulted in a high turnover in PFIs. The GF

is also subject to a lot of political interference with the board being replaced every time there is a new government.

Summary/Best Practice

The rebate on interest concept is a very effective one when properly implemented. It encourages good behavior on the part of borrowers and also helps drive down interest rates. However, ACGSF has undermined this very innovative concept by not making rebate payments as promptly as promised and this has undermined confidence in the fund.

A1.3 Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE), India

Background:

This scheme was designed and piloted by the Small Industries Development Bank of India (SIDBI) in 2000 initially working only with state owned banks but expanding in 2007 to cover large rural banks. Fund size as of March 2010 was US\$ 406 million (Government of India Ministry of SMEs contributing US\$ 325 and SIBDI contributing US\$81 million). More funds had been committed by both parties. Objectives of the scheme are to encourage lenders to extend credit for both working capital and term loans to MSMEs and also to focus their appraisals more on the viability of projects instead of collateral. All startups, micro and small enterprises in the manufacturing and service sectors as defined by Indian laws are eligible to apply for credit.

Structure

- i) A retail/single loan guarantee with guarantee process only starting after bank has approved loan and disbursed funds. The bank then uses an online portal to submit details of the loan

and apply for coverage. CGTSME may or may not accept the coverage.

- ii) Guarantee covers any collateral and third-party free loans up to a maximum of US\$200,000.
- iii) Amount of loss coverage varies depending on amount and the borrower. For instance, microenterprises borrowing less than US\$ 10,650 get a cover of 85% while SMEs borrowing more than \$106,500, get a 50% coverage of the amount of \$10,650 up to a maximum of \$133,000.
- iv) For working capital, cover can extend to a maximum of 5 years while term loans get coverage for the specific term of the loan.
- v) Lending institutions get charged a one-time, up-front guarantee fee of 1-1.5% and an annual service fee of less than 1% for each account covered. Fees are on principal amount borrowed rather than outstanding amount.
- vi) There is a lock-in period of 18 months from the date of the guarantee, within which PFIs cannot submit claims. If a default happens within the lock-in period, PFIs have to wait a year from the default date before submitting the claim. If the default happens after the lock-in period, a claim can be submitted immediately. Also, it is requirement that lawsuits against defaulters be initiated before a claim can be submitted to the fund.
- vii) The fund creates awareness of its existence to banks and other lenders as well as entrepreneurs by holding regular workshops.

Performance

The scheme's uptake was gradual but slow between the years 2000 and 2008. However, this picked up in 2009. By March 2010, the scheme had registered approximately 110 PFIs across India, of which 81 had used the guarantee. 300,000 loans had been approved for guarantee cover for a cumulative total of US\$2.5 billion. More than half of the approved loans were

for loans to microenterprises. The fund had received 4,761 claims of which it had 2,506 for a total of US\$11.28 million. Of the remaining claims, half were pending while the others were ineligible or incomplete. During the same period, the fund received over US\$ 40 million in fees from PFIs.

Banks have complained that the fund is very slow in paying claims even after having to endure the long lock-in period. A 2010 review of the scheme also recommended that the fund starting a portfolio product for registered PFIs.

Summary/Best Practice

CGTMSE is unique in that it is a retail GS on a huge scale. In 2010 alone, it approved over 100,000 cover applications. Even with its use of ICT to ensure efficient data entry by PFIs, this approach does not seem sustainable in the long run. It is also very interesting that PFIs only get guarantee cover after they have approved a loan and disbursed the funds. This would explain the slow uptake of the scheme's usage between 2000 and 2008 as the bank has already taken all the risk even before submitting a cover application to the fund.

A positive lesson from this scheme is its graduated loss coverage which favors lending to microenterprises (up to 85% coverage) as opposed to using a standard 50% coverage. This has greatly enhanced lending to microenterprises. Manufacturing firms also get a higher coverage ratio than service firms which has also favored lending to manufacturers. The coverage ratio can therefore be used to specifically target groups that the guarantor may be interested in developing. It is also of interest that the fund has received more in fees from PFIs than it has paid in claims.

A1.4 Korea Credit Guarantee Fund (KODIT)

Background

KODIT, is an independent, government sponsored institution providing comprehensive support for SMEs. KODIT was started in 1976 and since then has scaled up its activities to the point that, during the recent financial crisis, outstanding guarantees reached approximately 4% of South Korea's GDP. The objective of KODIT is to lead the balanced development of the national economy by extending credit guarantees for the liabilities of promising SMEs which lack tangible collateral.

Structure

- i) All profit seeking enterprises are eligible unless in real estate, financial services or hospitality .
- ii) Borrower applies for guarantee directly to KODIT after being advised to do so by bank. Borrower can visit KODIT offices in person or submit online application. KODIT conducts full appraisal and due diligence of borrower and approves or denies guarantee. If successful, borrower then goes back to bank with letter of guarantee and gets loan. Only about 3% of guarantees issued are issued directly by 13 banks which have been authorized to operate portfolio guarantees.
- iii) Once a letter of guarantee from KODIT is issued, borrowing firm is required to pay a guarantee fee which is very closely tied to the credit rating of the applicant. The fee ranges from 0.5% to 2% of guaranteed amount, although for larger SMEs, an extra 0.5% is added.
- iv) Coverage ratio depends on credit rating of borrower. For borrowers with low or no credit rating, coverage can extend up to 90% while borrowers with good credit rating get a minimum of 50% coverage.

The objective here is that as credit rating of a firm improves, there should be less need of a guarantee. KODIT's credit rating system is accessible to commercial banks and so KODIT is able to communicate which firms have credit good enough to qualify for unguaranteed commercial loans.

- v) KODIT is engaged in a variety of businesses including credit guarantee, business consulting, management of credit investigation, and management of credit information

Performance

KODIT started in 1976 with an initial capital of KRW 32 billion Korean Won and in that year, had outstanding guarantees of KRW 102 billion. In 2011, KODIT had a capital endowment of KRW 6.6 trillion and outstanding guarantees of KRW 45.5 trillion for a leverage of approximately 7 times. The fund has however been much more leveraged in the past (up to 17 times in 1993) and in fact, its maximum authorized leverage ratio is 20 times. Between 2008 and 2012, the default rate was between 4.5% and 5.0%.

Between 1992 and 2005, KODIT developed the largest database of credit information on Korean SMEs and acted as a credit bureau. Eventually, the bureau operations were spun off into an independent business.

KODIT has continued to innovate and currently has 11 types of general guarantees including guarantees for leases, trade bills, bond issuance, transaction liability etc.

During the Asian financial crisis of the late 1990s, Korea's economy was severely impacted but KODIT was able to lessen the impact by increasing loan guarantees to ensure continued lending by banks.

In 2010, KODIT launched the "Online Loan Market" project, aimed at improving the

exchange of information between borrowers and lenders. This is an internet platform that enables Korean SMEs to exchange lending information with banks and select the institutions that offer them the most favorable conditions. The service is also expected to benefit the banks, since they can reduce their marketing costs when searching for new SME customers.

Summary/Best Practice

KODIT is an example of a highly successful guarantee scheme that is unique in its approach to the business. Unlike most schemes which are buffered from the final borrowers by PFIs, KODIT deals directly with borrowers. This is a much more resource intensive approach and would probably not work for small GSs. However, the impact of this approach is greatly magnified as KODIT started operations at a time when commercial banks would not lend to SMEs and took matters into its own hands. By doing its own due diligence and over time developing credit histories for SMEs, it was able to manage its own losses while at the same time giving banks greater reassurance on SME lending. Its continuous innovations also continue to stimulate credit in favor of SMEs.

A1.5 Credit Guarantee Corp of Malaysia (CGCMB)

Background

The Credit Guarantee Corporation Malaysia Berhad (CGCMB) was incorporated on the 5th of July 1972 under the Companies Act 1965. The share capital of CGCMB is held jointly by Bank Negara Malaysia (the Central Bank of Malaysia) at 76.4% and a consortium of commercial banks and finance companies operating in the country at 23.6%. CGCMB was established primarily to assist SMEs, especially those without or with inadequate collateral and without business track record,

gain access to financing from the participating financial institutions at a reasonable cost. It is also to assist the government with its efforts in promoting and developing identified business sectors.

Structure

- i) Initially targeted at providing working capital and capital asset investment finance to small enterprises in agriculture, commercial and industrial sectors but has since expanded to include medium sized companies.
- ii) Uses risk-adjusted pricing structure where the guarantee fee charged would correspond to the risk profile of the SME borrower. An enterprise with a lower risk rating would be able to get better pricing compared to an enterprise with a higher risk rating.
- iii) Cover ranges from 30% to 100% depending on the guarantee product used. Where there is no financial institution acting as an intermediary, loans can be covered up to 100% as the moral hazard risk is not inherent.

Performance

Since inception, has introduced over 40 different products in response to changing economic demands. For instance, following the Asian Financial Crisis of the late 1990s, banks tightened their lending practices, adversely affecting SMEs. In response to this, CGCMB introduced the Direct Access Guarantee Scheme where borrowers could apply directly to the fund without having to first approach a bank. Another example would be the introduction of the Loan Fund for Hawkers and Petty Traders (LFHPT) which was aimed at getting small scale entrepreneurs into the financial system as part of a government financial inclusion initiative. Finally, the fund offers a comprehensive range of guarantee products targeted at the Islamic banking sector.

Other innovations by CGCMB include:

- SME Loan Securitization: SME loans provided by banks are bundled together and sold to a secondary buyer who can get a guarantee from CGCMB on their performance. This becomes a source of funds for lending to SMEs as banks do not have to wait for SMEs to pay off their loans. They can simply sell off the loans and create new ones.
- Equity Funding: guarantee provided to private equity actors to encourage them to invest in SMEs.
- SME Credit Bureau: to keep track of the credit history of SMEs and provide a credit rating that can be used by financial institutions to make lending decisions.

In the four decades since its set-up, CGC has helped over 420,000 Malaysian SMEs, and, by the end of December 2012, had provided more than RM50 billion worth of guarantees.

Summary/Best Practice

The thing that is outstanding about CGCMB is the huge volume of products that it keeps coming up with in response to demand and events in the economy. The fund also emphasizes the use of risk management tools to price guarantees at the borrower level such that each borrower pays fees commensurate to the borrower's risk.

A1.6 Fondo Especial de Asistencia Técnica y Garantía para Créditos Agropecuarios (FEGA), Mexico:

Background

FEGA was established in 1972 as one of the trusts under Fideicomisos instituidos en Relación con la agricultura (FIRA), a publicly owned and capitalized development financial institution in Mexico. Its main objective is to provide technical assistance and guaranties to agriculture and other related sectors. FIRA's trusts target a wide range of rural productive farm, agro-processing and micro- and small enterprises: any business-related project in the rural sector in communities with fewer than 50 000 inhabitants can apply for FIRA coverage. FEGA is the trust with the most direct coverage of agriculture and agribusiness along the commodity value chain.

Structure

- i) Trust is ran by an independent board made up representatives from the government, central bank commercial banks, agricultural industries and farmer organizations.
- ii) Cash deposit of guarantee fund amount made at PFIs.
- iii) Fees are payable by borrowers and are of two types; risk compensation component and a fee to cover the operational costs of the trust.
- iv) Guarantees are offered both in US dollars and local currency. The coverage ratio of the guarantee then depends on the currency of the loan as well as the type of intermediary involved i.e. bank or non-bank. Average coverage is 63%.
- v) Guarantees are regulated by monetary and fiscal authorities in Mexico.
- vi) Beyond its fees, FEGA stays self-sufficient by ensuring healthy earnings from its investments i.e. treasury earnings.

Performance

As of November 2010, FEGA's capital stood at US\$990 million. Total guarantees outstanding amounted to US\$1.9 billion on a loan portfolio of US\$3.8 billion.

Summary/Best Practice

The continuity of highly professional and competent leadership at FEGA has ensured its continued success and sustainability. It is also important to note that FEGA relies only on its own earnings to finance its importance and it does this through fees and even more importantly, earnings from its investments.

A1.7 Fondo Garantia para Pequeños Empresarios (FOGAPE), Chile

Background

The Fund of State Guarantee for Small Industrialists was established in 1980 by a statutory act but did not really make an impact until its re-launch in 2000 (re-launch made it more independent from the government and addressed complaints of late payment on claims from banks). The fund's capital is all provided by the Chilean government

Structure

- i) Fund is managed day to day by a special unit within Banco Estado, the state owned bank, which charges the fund an administration fee. A consultative committee, which includes representatives from the four largest banks, three associations of SMEs and the Ministry of Economy, and the Fund supervisor within Banco Estado, meets quarterly.
- ii) Banks select which loans they wish to be guaranteed and do the entire risk appraisal. FOGAPE verifies that the loan is eligible for a guarantee.

- iii) In most cases, borrowers are completely unaware of the existence of a guarantee on their loans.
- iv) PFIs have to bid at an auction on a quarterly basis for the right to use the guarantee in the next quarter. They do this by declaring the coverage ratio or risk percentage that the bank needs FOGAPE to cover. Those with the lowest bids are the ones that get their requested amounts accepted in full.
- v) Maximum coverage is 70% though for loans with terms of less than 3 years, this can increase to 80%
- vi) The fund's guarantee fees are derived in such a way as to be able to fully meet operational costs of the fund as well as claims, while treasury earnings are used to increase the fund capacity.
- vii) The fund's regulations set out a maximum leverage of 10 times as well as a requirement to set aside a reserve of at least 4% of outstanding guarantees.
- viii) The fund provides a lot of training to the staff of PFI especially in the use of guaranteed loan products to service small and micro enterprises.
- ix) The fund hosts a monthly call to PFIs to disseminate information on its portfolio of guaranteed loans. In this way, the fund gets out information on the risk levels in the market and the PFIs adjust accordingly
- x) Claims are paid out in full within 15 days.
- xi) Fees charged to PFIs are continuously adjusted to reflect the volume of claims submitted such that those banks with more claims get charged higher fees. In one case, a bank had its participation suspended once its claim volumes became too high.

Performance

- i) Default rate net of recoveries has averaged 2.5%

- ii) In the first five years after re-launching the fund, 2,500 bankers had received training from the fund.
- iii) All PFIs using the scheme have seen increased lending to SMEs since the fund was re-launched
- iv) A 2006 study by Larraín and Quiroz for Banco del Estado, found that FOGAPE was responsible for a 40% increase in credit in Chile

Summary/Best Practice

FOGAPE's success to a large extent can be attributed to its understanding and embracing of a market approach. Rather than delay claims as a means to keep them down, the fund pays efficiently as demanded by the market but finds ways to keep claims down by penalizing those with higher claims.

The quarterly auction where PFIs bid to use the scheme also serves as a discovery mechanism. Rather than having the fund set out arbitrary and uniform coverage rates and volumes, the fund lets PFIs state their needs and rewards those that help keep the fund sustainable. The PFIs most likely to get their requests accepted in full are those that are willing to ask for lower coverage ratios. This means that they are more willing to share in the risk which hopefully also reflects increased risk management sophistication on the part of those PFIs.

A1.8 Invega, Lithuania

Background

Was established by the government of Lithuania in November 2001 but is incorporated as a private limited liability company. The purpose of INVEGA activities is to promote the development of small and medium-sized enterprises in Lithuania facilitating their access to the sources of financing. The Invega guarantee scheme is supported by the European Investments

Fund's 50 % counter-guarantee under the SME guarantee facility's 'loan guarantees' window.

Structure

- i) Retail guarantee with bank reviewing every application from bank before approval.
- ii) ii) Uses a 'first installment' approach whereby Invega takes the first risk for non-repayment of the loan. After the debtor repays the bank the guaranteed part of the loan, Invega's guarantee ends.
- iii) Banks only require collateral up to the unguaranteed part of the loan e.g. if the loan is for \$100,000 and Invega guarantees 50%, the bank may only take collateral for the unguaranteed \$50,000.
- iv) Invega also requires the borrower to put up at least 20% collateral for the loan. In this way, all parties i.e. the borrower, bank and Invega share in the risk, though Invega bears the largest risk.
- v) Usually has a coverage ratio of 50% but can cover up to 80% for microloans. Finances tangible investments, intangible investments e.g. acquisition of patents, working capital and refinancing of investments from enterprise funds. Does not cover agriculture related investments.
- vi) Has maximum loan limits (EUR 289,600 for investments and EUR 145,000 for working capital)
- vii) Firms that have been in existence for more than 3 years qualify for higher guaranteed loan amounts than those that are younger.
- viii) Guarantee fees also depend on age of enterprise. Those in existence for less than 3 years get charged 4% while those in existence for longer than 3 years are charged 3%.
- ix) Claims can be submitted immediately upon default and Invega will pay 50% of the claim amount immediately. The rest is paid upon realization of collateral.

Performance

Since inception, Invega has issued more than three thousand guarantees. The scheme's PFIs have expressed satisfaction and confidence in Invega's prompt payment of claims. It also helps that Invega offers a sovereign guarantee backed by the government of Lithuania.

Summary/Best Practice

The 'first installment' approach is unique and achieves the goal of the guarantee scheme in a very efficient manner. Invega is able to get out of guarantees more quickly by terminating the guarantee as soon as the guaranteed portion of the loan is paid back. In this way, it is able to free up capital for issuing more guarantees. The bank on the other hand also finds this approach useful because it is in the early part of a project that success is usually determined. So if the borrower is able to pay off the initial half (or whatever guaranteed proportion of the loan), it stands to reason that the project is in good shape and most of the principal has been paid off meaning that the borrower has a less challenging financial burden.

A1.9 Enterprise Finance Guarantee, United Kingdom

Background

EFG was introduced in January 2009 by the UK government in response to the credit crunch, to address the market failure in the provision of debt finance, whereby viable businesses are unable to obtain normal commercial loans, because they lack adequate security or a proven financial track record.

Structure

- i) It is a portfolio guarantee with the fund having no role in the application or decision making process.
- ii) Coverage ratio of 75%

- iii) Government exposure is limited to 9.75% of the scheme value meaning that once this limit is reached, banks are responsible for all subsequent limits. This is meant as an incentive for banks not to attach bad loans to the scheme.
- iv) Borrower pays quarterly fee of 2% of outstanding loan amount.
- v) Loan terms can vary from 3 months to 10 years and amounts can be up to £1 million.
- vi) Scheme allows co-guarantees and collateral.

Performance

- i) EFG is responsible for up to 2% of all term loans issued by UK banks to SMEs.
- ii) In 2009 only, EFG's guarantees resulted in a net economic benefit to the economy of £1.1 billion.
- iii) Had a default rate of up to 28% before recoveries. This high rate can be explained by the fact that the SMEs were operating in very difficult economic conditions between 2008 and 2012.
- iv) EFG conducted a study on the impact of the scheme in its first year and was able to use the results of that study to make adjustments to the scheme that made it more efficient. For instance, the application process for borrowers previously took

up to three months leading to loss of interest by applicants. Changes were made that resulted in this application period reducing to less than a month.

- v) A key finding of that study is that only 6% of successful borrowers stated that they would have received a loan without EFG, meaning that EFG was able to provide added value i.e. was responsible for loans that would otherwise not have been made.
- vi) By October 2012, EFG had generated £1.73 billion in loans. It continues to target £600 million to 6,000 SMEs each year.

Summary/Best Practice

EFG demonstrates the value of assessing a GS's performance as early as possible in order to make appropriate adjustments. It is also critical to always ensure the added value of the scheme as the ultimate objective of the guarantee scheme should be to create new credit.

ANNEX 2: LIST OF PERSONS INTERVIEWED

Organization	Individuals Interviewed
Government of Tanzania - Ministry of Finance	Mr. Alfred P. Misana, Deputy Commissioner, Policy
Government of Tanzania - Ministry of Industry and Trade	Ms. Joyce R. Meru – Asst. Director, SME Department
SIDO	Mr. Mafwimbo B. S., Director of Finance and Administration
Bank of Tanzania	Mr. Charles H. Kimaro – Manage, Credit Guarantee Schemes Department
	Ms. Fatuma Kimario – Asst. Manager, Credit Guarantee Schemes Department
CRDB Bank	Mr. Anderson Mlabwa – Director of Credit
	Mr. Xavery Makwi – Senior Manager, loan Approval
	Mr. Elibariki Masuke – Manager, SME Banking
	Mr. Musa Thomas Lwila – Senior Credit Analyst
NMB Bank	Mr. Isaac Masusu, Commercial Manager Agribusiness
Exim Bank	Mr. Praveen Mehra, Head of Credit
National Bank of Commerce	Danstan Kolimba, Relationship Manager – Public Sector and Institutions, Corporate & Investment Banking
	Melvin Saprapasen – Trade Finance – Corporate and Investment Banking
Stanbic Bank	Mr. Sylvester Ngenzi, Manager – Agricultural Banking
FBME Bank	Mr. Nassor Rajab Dachi, Head of Branch Operations
	Mr. Marwa Joseph Moherai, Head of Credit
	Mr. Minesh Ghella, Credit Manager
Tanzania Women’s Bank	Margaret Chacha, Managing Director
Barclays Bank	Mr. Khalifa Zidadu, Head of Large Corporates - Corporate Banking
Bank of Africa	Mr. Eric Ouattara – Deputy General manager, Risk Management
	Ms. Davikirani Williams – SME Banking Manager
Akiba Commercial Bank	Mr. Honest Baimu, Commercial and Corporate Banking Manager
Kenya Commercial Bank (KCB)	Ms. Virginia Mwangi – Relationship Manager, SME
	Ms. Clarisse Aduma – Agribusiness Development Manager
Swedish International Development Agency (SIDA)	Ms. Anna Skantze
Canadian International Development Agency (CIDA)	Mr. Jared Duhu – Private Sector Development Specialist
Danish International Development Agency (DANIDA)	Mr. Samweli Kilua, Programme Officer, Business Sector
Agence Française de Développement (AFD)	Mr. Dennis Munuve – AFD Country Representative Tanzania
Rabobank	Mr. Nafal Hassani-Mohamed – Charge de Projects
	Mr. Sierk Plaat – Senior Analyst, Africa
Kilimo Trust	Mr. Kees Verbeek, Senior Relationship Banker
Private Agriculture Sector Support (PASS) Trust	Prof. Nuhu Hatibu
African Guarantee Fund	Mr. Iddy Lujina, Managing Director
USAID-DCA	Mr. Passwell Shapi, Director of Business Development
World Bank	Mr. Kevin McCown
World Bank	Mr. Mustafa Hussain, Senior Energy Specialist Africa Region

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For more information about this analysis-conduct

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