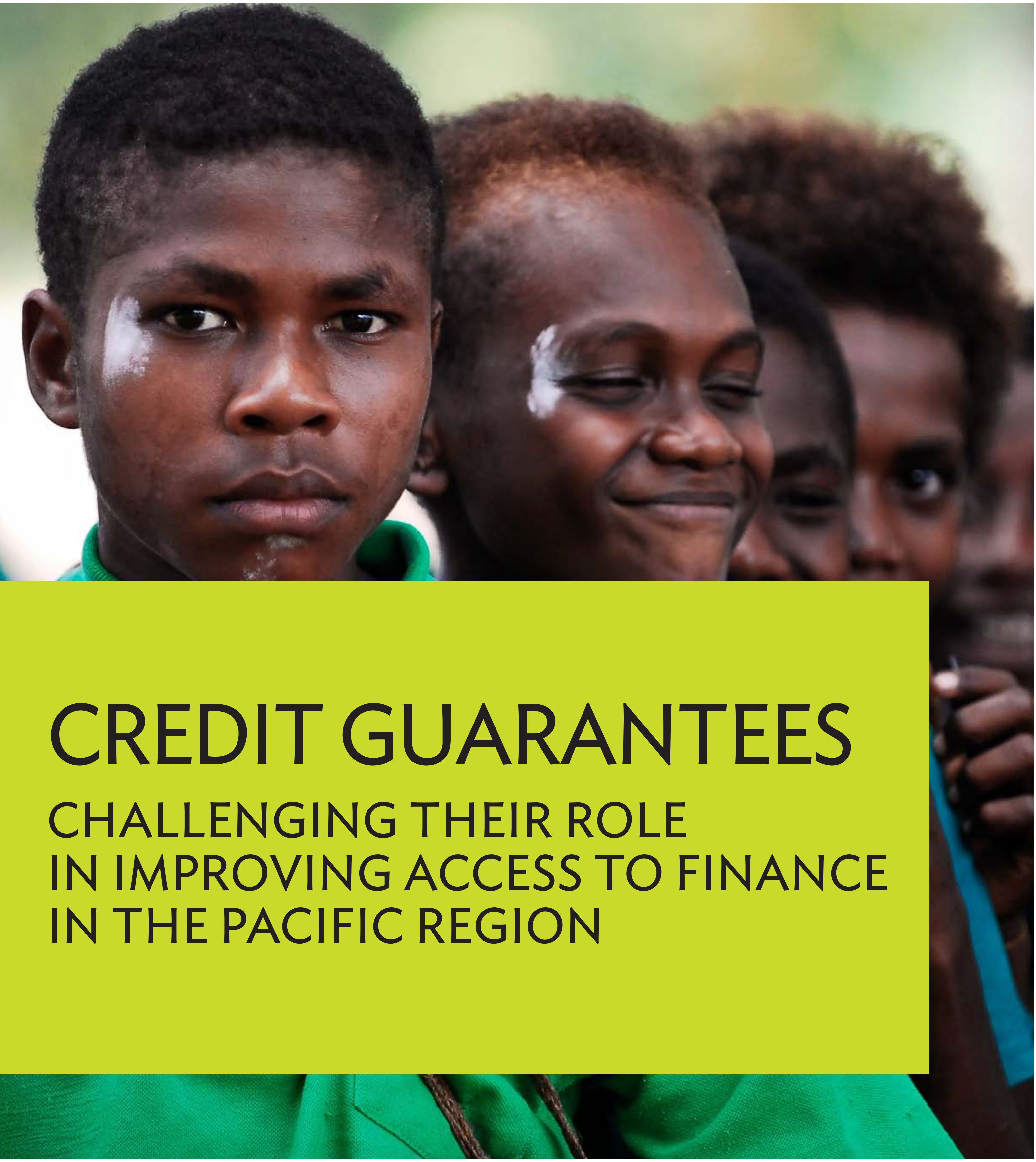

CREDIT GUARANTEES

CHALLENGING THEIR ROLE IN IMPROVING ACCESS TO FINANCE IN THE PACIFIC REGION

ASIAN DEVELOPMENT BANK

50 YEARS

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CONTENTS

ABBREVIATIONS

ADB	Asian Development Bank
BSP	Bank South Pacific
CBSI	Central Bank of Solomon Islands
IDA	International Development Association
IFC	International Finance Corporation
GDP	gross domestic product
MSEs	micro and small-sized enterprises
PNG	Papua New Guinea
RBF	Reserve Bank of Fiji
SFLG	Small Firms Loan Guarantee Scheme
SMEs	small and medium-sized enterprises

CURRENCY EQUIVALENTS

(as of 21 January 2016)
Unless otherwise stated, "$" refers to US dollars.

Currency unit = Fiji dollar/s (F$)
F$1.00 = $0.46
$1.00 = F$2.18

Currency Unit = kina (K)
K1.00 = $0.33
$1.00 = K3.02

Currency Unit = tala (ST)
ST1.00 = $0.38
$1.00 = ST2.65

Currency Unit = Solomon Islands dollar/s (S$)
S$1.00 = $0.12
$1.00 = S$8.17

ABOUT THE PACIFIC PRIVATE SECTOR DEVELOPMENT INITIATIVE

The Pacific Private Sector Development Initiative (PSDI) is a regional technical assistance facility cofinanced by the Asian Development Bank (ADB), the Government of Australia, and the Government of New Zealand.

Since 2006, PSDI has been working with ADB's 14 Pacific developing member countries to improve the enabling environment for business and support inclusive, private sector-led economic growth. Its expert team provides support services in policy and program development, advocacy, legislative and administrative reform, and capacity building.

All PSDI publications can be downloaded from www.adbpsdi.org.

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1. INTRODUCTION

Banking sectors across Pacific island countries have not yet reached the point where they effectively intermediate between savers and borrowers. Despite adequate liquidity, commercial banks are often reluctant to extend business credit, which is a serious constraint to business operations and broader economic development. In quantitative terms, the ratio of private sector credit to gross domestic product (GDP) in Pacific countries is less than 50%,[1] with the exception of Fiji and Vanuatu. In faster growing and more developed economies, this ratio typically approaches or exceeds 100% (Appendix 1).

SECURED TRANSACTIONS: SOLVING THE PROBLEM OF COLLATERAL

The difficulty in using real assets as collateral has undoubtedly been a major factor affecting banks' willingness to lend, but this excess liquidity has remained pervasive despite widespread secured transactions reform across Pacific countries over the last decade.[2] Secured transactions reforms address the problems with collateral: the new secured transactions laws allow security interests to be created in various forms of moveable property, such as equipment, inventory, accounts receivable, crops, livestock, and shares. This enables businesses to pledge moveable assets, making it easier for banks to take on additional forms of collateral as an alternative to real property and reducing the risks of losses in the event of default.

Credit guarantees are often promoted as an instrument to overcome the lack of lending. Credit guarantee schemes have existed for over two centuries, having emerged first in Europe. Today, they are widely prevalent in both the developed and developing worlds.[3] Credit guarantee schemes can take several forms, with the main variants being guarantees of individual loans and guarantees of a portfolio of loans. Within these variants, there are many alternatives for allocating risk, ranging from a 100% guarantee of a loan or portfolio, to a lesser proportion, depending on the types of loans, risks, and maturities.

Several credit guarantee schemes already exist in the Pacific (Appendix 2), and proponents advocate for the introduction of schemes, where they currently do not exist. This paper aims to increase awareness of the policy issues surrounding credit guarantees. In so doing, it challenges the arguments for using guarantees and, furthermore, argues that credit guarantees are unlikely to provide an effective solution to the lack of access to credit faced by businesses.

1 The ratio of private sector credit is the most commonly used indicator of access to finance and generally considered to be the best indicator of financial sector development. T. Beck, R. Levine, and N. Loyaza. 2000. Finance and Sources of Growth. *Journal of Financial Economics*. 58. pp. 261–300.

2 The secured transaction framework has been reformed in the Marshall Islands, Federated States of Micronesia, Palau, Papua New Guinea, Solomon Islands, Timor-Leste, Tonga, Vanuatu. Reform is also under way in the Cook Islands, Fiji, and Samoa

3 A 2003 United Nations Industrial Development Organization (UNIDO) report noted the existence of around 2,250 schemes in almost 100 countries. A. Green. 2003. Credit Guarantee Schemes for Small Enterprises An Effective Instrument to Promote Private Sector-Led Growth? *SME Technical Working Papers Series*. No. 10. Vienna: UNIDO.

QUESTIONING THE CASE FOR CREDIT GUARANTEES

There is no strong theoretical justification for the use of credit guarantees. However, especially when the reasons for the failure of banks to provide business finance have more to do with an unwillingness to lend than risk aversion. Furthermore, finance theory suggests that when a guarantee is priced correctly to incorporate the risk of non-repayment, a guarantee will have negligible impact on lending. This is because the default risk will be reflected in the cost of any guarantee and ultimately the interest rate charged to a borrower.[4]

Practical experience also suggests that there is a weak case for using credit guarantees to increase business access to finance. There are isolated examples of success, but few rigorous evaluations of guarantee schemes have been undertaken. Where the schemes have been deemed successful, they do not demonstrate an increase in lending relative to what would have occurred without any guarantee. None of the active credit schemes in the Pacific have resulted in any appreciable increase in lending and several have suffered significant losses. Moreover, to make a substantial difference to the amount of credit granted, guarantee schemes would have to be very large, and well beyond the scale of the schemes operating in the Pacific region.

The activities of nonbank credit institutions, such as finance companies and development banks in the Pacific also call into question the case for credit guarantees. In contrast to commercial banks, these institutions, and even some large wholesalers, have either actively embraced the opportunities afforded by secured transactions reforms—the Credit Corporation Group is one such example—or are actively exploring opportunities to introduce new instruments, such as agriculture supply chain financing, secured against buyer contracts, inventory, and accounts receivable. Provident funds—an important source of credit in the Pacific—have also been also been actively searching for lending opportunities. Governments have come to see both development banks and provident funds as essential to financing growth opportunities when commercial banks have been reluctant to do so.

These actions undermine the case for a more extensive use of credit guarantee schemes in the Pacific. Furthermore, and even more troubling, is the real prospect that resorting to credit guarantees will stifle the development of credit assessment and risk management capabilities in Pacific banks, including the development of credit assessment methodologies better suited to the reality of Pacific business conditions. Rather than seeing credit guarantees as the solution to access to credit constraints, the paper promotes a comprehensive reform of the business environment, alongside a greater use of secured transactions frameworks, and the promotion of other nonbank credit instruments, such as trade credit.

The paper is structured as follows: Section 1 gives a brief introduction of the issues. Section 2 provides the starting point for the discussion with an outline of a conceptual approach to barriers to lending. Section 3 provides an overview of the design features of credit guarantees. The Pacific experience with credit guarantees is addressed in Section 4, and this is followed by a discussion of the wider international experience in Section 5. These experiences with the use of credit guarantees in the

4 M. Gudger. 1998. *Credit Guarantees: An Assessment of the State of Knowledge and New Avenues of Research.* Food and Agriculture Organization of the United Nations.

Pacific region and elsewhere are not encouraging but, as discussed in Section 6, an increased use of trade credit and deeper business environment reform will underpin a sustained increase in credit. The paper concludes with a summary of the main arguments provided throughout.

2. THE CHALLENGES OF LENDING

In order to lend profitably to businesses, lenders need to be confident that loans will be repaid in a timely fashion, in accordance with lending covenants. In any financial system, lenders face three critical problems in making lending decisions:

(i) **Asymmetric information.** Recipients of loans always know more about their businesses than lenders ever can. (This is one of the main sources of lending risk).

(ii) **Moral hazard.** Since borrowers are using another party's finance, their incentives to take risks increase.

(iii) **Adverse selection.** If lenders overprice risk, the only borrowers to which they can lend are those who earn very high rates of return on their investments. The risk of nonrepayment of loans increases in these cases.

Lenders have typically dealt with these problems by requiring borrowers to pledge collateral as security against nonrepayment of loans. The fact that default leads to the forfeiture of the collateral reduces the chances of risky behavior or fraud. In almost all lending to smaller businesses, lenders also require a personal guarantee from borrowers so that business owners risk not only their business assets but also their personal assets.

Effectively dealing with these problems requires a sound legal framework for lending, which makes it simple and inexpensive to pledge assets as security, ensure that assets have not been pledged to another lender, and repossess them in the event of default. Pacific lenders have traditionally preferred real estate as collateral. Two problems with using real estate exist, however. First, much of the land in the Pacific is communally owned, which makes pledging difficult, even for those who hold land leases. Second, it is costly and time-consuming to repossess real estate in the event of default.

REVOLUTIONIZING BUSINESS LENDING THROUGH SECURED TRANSACTIONS

To address the problems of using real estate as collateral, extensive reforms of secured transactions frameworks have been undertaken in many of the Pacific island economies in recent years (footnote 2). These reforms have implemented a collateral framework for lending against movable assets that is among the most modern in the world.[5] Since lenders place substantial reliance on collateral in managing risk, these reforms have the potential to revolutionize business lending in the region. While the reforms have led to a significant number of new loans, they have not yet resulted in a substantial expansion in the availability of finance for businesses.

Many bankers have failed to appreciate how the reforms bring legal certainty to the priority surrounding a security interest and the ease of

[5] P. Holden et al. 2014. *Unlocking Finance for Growth: Secured Transactions Reforms in Pacific Island Economies*. Manila: Asian Development Bank.

enforcement procedures. Not surprisingly, the continued reluctance of many commercial lenders to utilize the new framework has promoted a search for additional instruments that will potentially lead to more lending,[6] hence the interest in guarantees.

[6] An exception is the Credit Corporation in Solomon Islands, which has increased its lending by a factor of 7 using the secured transactions framework.

3. GUARANTEES IN PRACTICE

Guarantee schemes typically take one of three forms:

(i) **Mutual guarantee associations or societies**, which are formed by a group of businesses or organizations, and which extend collective guarantees to loans issued to the members of the association.

(ii) **State schemes**, which involve budget support for lending to small and medium-sized enterprises (SMEs), or other target groups, or for particular purposes.

(iii) **Counter guarantees**, which are, in effect a form of reinsurance, and generally found in developed countries. Under this mechanism, a guarantee agency reduces its risk exposures by buying counter-guarantees for a portion of the guarantees it has issued.

Of interest is the rationale for these schemes, how the guarantee is structured, the risks, and ways in which these risks can be managed.

A CRITIQUE OF THE RATIONALE FOR CREDIT GUARANTEES

Credit guarantees have been justified on three main grounds:[8]

(i) The guarantor may have better knowledge of the risk of lending to certain businesses or sectors than lenders, so that providing a guarantee reduces information asymmetries and improves the access to credit of businesses.

(ii) Guarantee schemes can help diversify risks among lenders.

(iii) If the guarantor is subject to the same regulatory requirements as the lender, there is greater potential to advance credit to particular borrowers.

In considering the validity of these justifications for Pacific island economies, an important consideration is that commercial bank behavior in the Pacific can be characterized more as an unwillingness to lend, rather than risk aversion—where the risk-adverse investor demands a premium over the market rate.[8] In these circumstances, are guarantees an effective means to promote increased lending?

Some advocates of guarantees claim that, if some percentage of a bank loan is guaranteed, banks can be induced to make unsecured loans. However, this does not address the issues of asymmetric information, moral hazard, and adverse selection discussed above. Lending practices in most high-income countries support this contention. In the United States, over 70% of business loans are secured by movable property, and less than 10% of

[7] For more details, see P. Honohan. 2008. Partial Credit Guarantees: Principles and Practice. A paper prepared for the Conference on Partial Credit Guarantees. Washington, DC. 13–14 March.

[8] Z. Bodie, A. Kane, and A. Marcus. 2005. Investments. 6th ed. Singapore: McGraw Hill. p. 168. Bodie, et al. define the risk-averse investor as "one that is willing to consider only risk free or speculative prospects with positive risk premia… Loosely speaking, a risk-averse investor 'penalizes' the expected rate of return of a risky portfolio by a certain percentage (or penalizes the expected profit by a dollar amount) to account for the risk involved. The greater the risk the larger the penalty."

all loans by commercial banks to nonpublicly listed corporations are unsecured.[9] In general, guarantees without any form of collateral are not a solution to a lack of credit for business.

Further, an often-overlooked point is that a guarantee scheme would, theoretically, have no effect on lending when the guarantee is correctly priced. This is because the cost charged by the guarantor would reflect the calculated probability of loan losses, and this cost would be passed on to borrowers by the lender.[10]

This point sharpens consideration of the wider public policy issues surrounding credit guarantees. When the guarantee is not correctly priced, there is some distortion in the allocation of finance within the economy. If lending increases, the associated risks have merely been transferred to another party. There is no change to the probability of loan losses. Where the state provides guarantees, the cost of any loan losses will be borne by taxpayers. If donors provide guarantees, they will absorb any losses. However, the opportunity cost of so doing will still be borne by the population in the recipient country in the form of less funding of other initiatives, (e.g., for promoting health programs).

TYPES OF CREDIT GUARANTEES

Generally, guarantees can take two forms: the guarantee of individual loans; and the guarantee of a whole portfolio, with the proportion guaranteed determined by the structure of each scheme. Hybrids of individual and portfolio guarantees also exist.

1. **Guarantees of individual loans**. In the case of guarantees of individual loans, the guarantee may apply *pari passu*, where coverage applies equally and without preference to the principal, and where the amount of unpaid principal repaid to the lender by the guarantor is determined by the percentage of the loan guaranteed. Alternatively, the guarantee may apply to early or late tranches of scheduled principal payments, or to longer maturities, when short maturities are considered unduly risky.

   Guarantees may apply only to the unpaid loan balance of a defaulting borrower after any collateral is sold. The amount guaranteed could be limited to the unpaid principal, or could include unpaid interest and fees. The transaction costs of repossessing and selling collateral in the event of nonpayment could be borne by the guarantor or the lender, or shared between the two.

2. **Guarantees of portfolios**. Portfolio guarantees cover a larger number of loans. This approach may carry greater deadweight losses and involve less additionality, when lenders include loans that they would have made anyway, i.e., the moral hazard is larger than is the case with guarantees of individual loans. Moreover, there is no direct connection

[9] Sources: United States Federal Reserve, Board of Governors. 2010. *Federal Reserve Statistical Release, Financial Accounts of the United States, Flow of Funds, Balance Sheets and Integrated Macroeconomic Accounts*, Fourth Quarter 2010. Washington, DC; United States Federal Reserve, Board of Governors. 2012. *Federal Reserve Statistical Release, Financial Accounts of the United States, Flow of Funds, Balance Sheets and Integrated Macroeconomic Accounts*, Fourth Quarter 2012. Washington, DC; and United States Federal Reserve, Board of Governors. 2014. *Federal Reserve Statistical Release, Financial Accounts of the United States, Flow of Funds, Balance Sheets and Integrated Macroeconomic Accounts*, Fourth Quarter 2014. Washington, DC. This does not apply to smaller businesses that are financed through credit cards of the owner, a relatively common practice in the United States and some European countries.

[10] This point was made in the context of the provision of guarantees for student loans. G. Mankiw, G. 1986. The Allocation of Credit and Financial Collapse. *Quarterly Journal of Economics*. 101 (3). pp. 455–470.

between a lender and individual borrowers, further reducing the information available to a lender. These problems can be tempered by applying strict criteria for loan eligibility, loan size, or project activity, but care must be taken not to verge into directed credit and to preserve the market-orientation of banks' loan decisions. Portfolio guarantees could result in lower transaction costs for a guarantee agency, although it might be hard to quantify, ex ante, the costs of monitoring the loan criteria mentioned above.

3. **Hybrid guarantees**. A hybrid guarantee is a combination of individual and portfolio guarantees. Loans to a particular target population could be funded through a portfolio approach, whether in a particular sector or a class of borrowers (such as agriculture SMEs), in addition to guaranteed individual loans. Alternatively, loans of up to a certain size could be included in a portfolio guarantee, with individual guarantees applying above a certain specified loan amount.

COVERAGE, COST, AND RISK ALLOCATION

Guarantee schemes vary in terms of the coverage ratio (i.e., the proportion of a loan that is guaranteed), the term, and the way costs and risks are shared among borrower, lender, and guarantor. Whatever the configuration, international experience in the implementation of guarantee schemes shows that the risk of any particular scheme failing can be reduced through prudential oversight, good governance, and robust risk management systems.

Coverage ratios vary depending on the type of the loan, the maturity of the loan, and the riskiness of the loan. Many guarantee schemes in developed countries, and some in developing countries, have a coverage ratio of 100%.[11] But moral hazard is high in these cases, especially if borrowers are not subject to any penalty in the event of nonrepayment. Experience shows that a 100% guarantee encourages strategic defaults,[12] especially if employed in new schemes and in an environment of nascent or highly underdeveloped financial markets. In schemes that offer 100% coverage, the incentive for banks to perform due diligence, risk assessment, and loan recovery functions well is blunted, particularly if transaction costs of doing so are high.[13]

Guarantors have to put correspondingly greater effort into these functions. The lower the guarantee ratio, the greater the incentive for banks to perform due diligence, monitor loans, and pursue repossession in the event of default. The higher the coverage ratio, the greater the incentive for lenders to keep long-standing, lower risk borrowers out of a guarantee scheme and put riskier borrowers into the portion of their portfolio that is guaranteed.

When a lender has a loan guaranteed, the interest rate charged to the borrower should be lower than would be the case without a guarantee because the risk of loss is lower. Holden (1997) notes that

> ... [w]hen a percentage of the loan is guaranteed, the issue of how to split the risk

[11] T. Beck, R. Levine, and N. Loayza. 2000. *Finance and the Sources of Growth*. Washington, DC.

[12] Examples are schemes in Canada, Neatherlands, and Lithuania.

[13] In cases where secured transactions frameworks are unreformed, it is usually necessary for the creditor to go to court to get a repossession order, and for an officer of the law to undertake the recovery of pledged assets.

> premium is an important one. In general, banks have insisted on a substantial premium over prime interest rates, even though a significant portion of the loan is covered by a guarantee. Thus, the amount that the guarantor can charge borrowers for the guarantee must be limited if problems of adverse selection are to be avoided. If the guarantor charges a large amount on top of the banks, only very risky borrowers will apply for loans. Therefore, it is rare that the guarantor can charge a sufficient premium to cover the risk for covering a major portion of the loan.[14]

The fee level should also be consistent with a market-oriented guarantee scheme and promote a level playing field—promote contestable markets—to allow for private guarantee schemes, in addition to any government guarantee schemes.

It is important that some collateral pledge be part of any loan agreement subject to a guarantee, even though a major purpose of guarantees is to reduce the risk to the lender and, hence, the collateral demanded by the lender. As Holden (1997) notes,

> ... in practical terms guarantees are not a substitute for being able to secure loans against collateral. All the problems with unsecured lending exist with guarantees. All that a guarantee does is shift the risk, or some percentage of the risk, from the primary lenders, the banks, to the guarantors. None of the problems that exist in developing financial markets are solved by guarantees. There is simply no substitute for reform of secured transactions systems if financial markets are to adequately fund small and medium sized businesses. The history of failure of financial intermediaries is replete with cases of overly aggressive pursuit of lending opportunities (footnote 15).

In the Pacific, guarantee schemes have not increased the supply of credit materially. The risks to borrowers associated with business failure described in the preceding paragraph adversely affect the demand for credit. Raising the ratio of private sector credit to GDP requires that at least one, but preferably both, of the credit demand and supply functions move outward. Credit guarantee schemes do not appear to have this impact.

Responsibility for due diligence of any loan application covered by a guarantee scheme can rest with the lender or guarantor, or both. Clearly, the capability of either party is important to the allocation of this responsibility, as is the willingness to allow the other party to undertake the assessment. In principle, the party with the most to lose in the event of default should perform the loan assessment. In practice, it is not uncommon for both parties to do the assessment, essentially doubling the transaction costs of loan processing. An arrangement that deals with this problem is one where both the lender and the guarantor contract due diligence to a trusted outside party. This mechanism could also reduce political pressure to make loans to favored borrowers, if the lending or guaranteeing institution is government-owned. Similarly, the lender and

[14] P. Holden. 1997. Collateral Without Consequence: Some Causes and Effects of Financial Underdevelopment in Latin America. *The Financier*. 4 (1&2). pp. 12–21.

[15] In the United States, the most entrepreneurial business environment in the world, 8 out of 10 small businesses fail in the first 5 years. The probability that a successful entrepreneur starting a second business will succeed is one in three. P. Gompers et al. 2008. Performance Persistence in Entrepreneurship. *Harvard Business School Working Paper*. No. 09–028. Boston: Harvard Business School.

guarantor need to reach agreement on which party, or parties, has responsibility for collateral recovery in the event of default.

THE INHERENT RISK OF GUARANTEE SCHEMES

Experience with credit guarantee schemes show that the key factors that reduce the risk of failure are regulation and supervision, governance and management, and risk management.[16]

Regulation and supervision. Banks need to be confident in the financial strength and management of a guarantee scheme to encourage them to lend. Putting in place an appropriate regulatory and supervisory framework is one way to assure banks of the credibility of any guarantee scheme. Components should include minimum capital requirements, safety of investments of the guarantee fund, leverage, solvency ratios, limits on exposures, connectedness, coverage, and use of risk management tools.

Governance and management. Strong corporate governance, including the use of suitably skilled private sector personnel in government guaranteed schemes, is needed to ensure the proper administration of a guarantee fund. Safeguards to ensure that a scheme can be protected against political pressure will also be needed. The central bank or a financial system regulator should be the supervisor. Legislation may be required to establish and enforce standards. Auditors and possibly credit rating agencies should play a part, particularly if reinsurance or securitization is being used. Successful schemes rely on qualified and experienced staff, with credit evaluation skills and good knowledge of the culture of the borrower.

Risk management. Key components of a sound risk management framework include capital adequacy ratios that depend on default history, and that should be generally in the range of 10%–20% of outstanding guarantees; establishment of a risk fund with proper investment and valuation standards and liquidity requirements; real time loan portfolio quality evaluation and appropriate provisioning; and the use of generally acceptable accounting standards.

Guarantee schemes must promote financial market development. It is important that they are not "one-off" interventions to encourage a particular sector, but rather be available to guarantee commercial loans more generally. If guarantees are targeted, they risk engendering all the problems associated with attempts to "pick winners," as well as failing to promote a more general lending culture among financial institutions.

[16] J. Castellanos. 1997. The Financial Supervision of Loan Guarantors. *The Financier*. 4 (1&2). pp. 34–43. Quoted in A. Green. 2003. Credit Guarantee Schemes for Small Enterprises: An Effective Instrument to Promote Private Sector-Led Growth? *SME Technical Working Papers Series*. No. 10. Vienna: UNIDO.

4. COULD GUARANTEES INCREASE BUSINESS CREDIT IN THE PACIFIC?

In answering this question, it is important to keep in mind that the difficulty in using real assets as collateral has not been the sole reason for the difficulties businesses have had in accessing credit. There are several other contributing factors, including:

(i) fees for transactions services and international transfers are significantly more profitable than interest on loans, generating high rates of return on commercial bank equity;

(ii) commercial banks have substantial oligopolistic market power in the provision of financial services;

(iii) stringent prudential norms imposed by the parents of foreign bank branches often make it possible for the branch to lend only to larger corporations or to governments, reducing the incentive to take lending risks;

(iv) business have lacked the capacity to prepare business plans and funding proposals, the absence of which has made it difficult for lenders to make credit risk assessments; and

(v) credit information is weak or nonexistent, as not all countries have credit bureaus and where they exist they only collect "negative credit information." There are plans, however, for existing bureaus to collect "positive" credit information and some lenders are exploring proxies for credit information, such as mobile phone transactions history.

The availability of credit guarantees will not address most of these issues, and may even impede improvements to business plans and credit information. And, where these schemes do exist in the Pacific, most have been directed at increasing lending to SMEs. Even schemes that possess many of the

Some characteristics of guarantee schemes in the Pacific that our analysis has identified are:

- In general, schemes are targeted at increasing lending to small and medium-sized enterprises—in some cases by banks only, in others by a broader range of lenders.
- Most are public sector schemes, funded through the national budget, and sometimes with a contribution from a bilateral or multilateral donor (as a loan or grant to the national government for the purpose of funding the guarantee scheme).
- There is no general model for the administration of the schemes; administrators have included central banks (Fiji and Solomon Islands); dedicated public sector bodies (Kiribati, and Pohnpei in the Federated States of Micronesia); small business development centers (PNG and Samoa); contracted third parties (PNG and Samoa); and a donor (the International Finance Corporation in PNG).

continued on next page

Box continued

- Coverage ratios are either 50% (two schemes in PNG and one in Samoa), or 80% plus (PNG, Samoa, and Solomon Islands).
- The schemes are *pari passu* (coverage applies equally and without preference to principal).
- Earlier schemes guaranteed individual loans (PNG, Samoa, and Solomon Islands), but several portfolio-based schemes have been introduced recently (one in Fiji and two in PNG).
- Fees vary by scheme, from 0%–1% to 1% to "commercial."
- There are no cases of counter-guarantees, reinsurance, or securitizations.
- Risk-weighting of guaranteed portfolio for capital adequacy requirements is not always clear. If, for example, a percentage of a financial institutions loan portfolio is guaranteed, does this mean that the capital adequacy requirements against the portion of the portfolio that is guaranteed are correspondingly lower?
- Typically, there is no regulation and supervision of the schemes.
- The only scheme in which "private" (nongovernment) money is at risk is the World Bank's risk share facility in PNG, where the International Finance Corporation provides second-loss cover. However, this facility also includes first-loss cover through a World Bank grant-financed project, which reduced the fees payable on the commercial portion of the guarantee to levels acceptable to the banks, and significant technical assistance grants. It is, therefore, best characterized as a blended public–private scheme.

PNG = Papua New Guinea.

features outlined in the previous section have failed to make much difference to access credit in the Pacific region, as the following discussion demonstrates.

PACIFIC EXPERIENCE WITH GUARANTEES

Although comprehensive information can be difficult to obtain, it appears there are at least seven active credit guarantee schemes in the Pacific, although a number of others have been established, closed, and/or revived since the 1990s (Appendix 2). The overall performance of these schemes has not been encouraging and suggests that any proposals for further schemes be treated with great caution. Loan losses in two schemes—in Papua New Guinea (PNG) and Samoa—have been substantial. Other schemes have failed to guarantee many loans. An ongoing scheme in Solomon Islands has issued guarantees on only 59 loans over 5 years. (Two schemes in Fiji and PNG have been underway for less than 3 years, so drawing conclusions from any evaluation would be premature.)

THE LIMITS OF INCREASING PRIVATE SECTOR CREDIT IN THE PACIFIC THROUGH GUARANTEES

Guarantee schemes cannot support more than a very small proportion of credit granted in an economy. Even Pacific island economies, where the amount of credit to the private sector is relatively low, new credit granted each year amounts to over $100 million. Table 1 illustrates this point based on the assumption that credit turnover or loan renewal occurs on average every year.[17]

Even in Tonga, the smallest country in the example, any credit guarantee scheme would have to total over $5 million under the assumption that credit turnover occurs every 2 years, or $11 million on the assumption that it occurs every year. For PNG, the amount would need to be $116.5 million for a credit turnover every 2 years, and $333 million for every year. Clearly, these amounts are larger than even the most ambitious donor-sponsored guarantee schemes.

This discussion also begs the question of the cost effectiveness of guarantee schemes. Simply saying that "there is additionality" is not sufficient justification for the time that designing and implementing a small credit guarantee scheme would take, even before allowing for expected losses.

[17] These assumptions lie at the low end of loan turnover. Since most bank credits to the private sector are supplied by commercial banks, the average term of loans is significantly less than 2 years, and could even be less than 1 year, which would imply that total renewed credit to the private sector could be at least total private sector credit at any particular moment in time.

5. INTERNATIONAL EXPERIENCE WITH CREDIT GUARANTEE SCHEMES

A more complete assessment of the potential role for credit guarantees in the Pacific needs to incorporate international experience with credit guarantee schemes. A comprehensive review of guarantee schemes beyond the Pacific is outside the scope of this paper, however, and unfortunately there is only minimal literature that addresses the effectiveness of guarantee schemes. Further, since the size of guarantees can be large and the number of participants in any scheme relatively small, evaluation does not lend itself to randomized controlled trials. A further major drawback to rigorous evaluation is that counterfactuals are not available.

For the most part, then, only general conclusions can be drawn. Earlier sections of this paper pointed to the weak theoretical foundations of guarantee schemes, and the general experience with the implementation of these schemes is not positive, as in the Pacific. While there may be a few examples of apparently successful schemes, the practical implementation of good design, risk management, and prudential oversight is too demanding to achieve more than isolated success.

The review of a widely heralded credit guarantee scheme in Colombia reinforces this point.[18] It states that, although risks factors were kept low, the administrative costs of ensuring a strong portfolio were over 10%, with the result that the scheme could not generate sufficient revenue to be self-sustaining. Generalizing, the author concludes, "the experience of all guarantee funds, whether in

Table 1: The Value of Credit Guarantees Necessary to Increase the Private Sector to Gross Domestic Product Ratio by 5 Percentage Points Assuming an 80% Guarantee[a]

Country	Total Private Sector Credit ($ million)	Ratio of Private Sector Credit to GDP (%)	Guarantee Scheme Size Necessary to Increase the Ratio of Private Sector Credit to GDP by 5 Percentage Points ($ million)
Fiji	2,552	62	102
Papua New Guinea	4,660	29	186
Samoa	327	47	13
Solomon Islands	210	18	8.5
Tonga	130	27	5

GDP = gross domestic product.

[a] The amount of new credit granted per year is calculated in the following way. If the average term of credit granted is 1 year, then assuming total private sector credit neither increases nor decreases, renewed loans will equal the amount of total credit to the private sector. Thus, in the case of Fiji, it would amount to $2,552 million. To increase credit to the private sector by 5 percentage points, an 80% guarantee scheme would have to amount to $102 million (5% of $2,552 million*.8).

Source: Based on calculations taken from International Monetary Fund. International Financial Statistics. http://data.imf.org/?sk=5DABAFF2-C5AD-4D27-A175-1253419C02D1.

[18] M. Gudger. 1997. The Sustainability of Credit Guarantee Systems. *The Financier*. 4 (1&2). pp. 30–33.

Germany, Italy, the United Kingdom, the Philippines, Nepal or Colombia confirms that it is difficult to create sustainable guarantee funds" (p. 30).

The experience of the two best-known, large-scale schemes further reinforces the point.

1. **The Small Firms Loan Guarantee Scheme (SFLG) in the United Kingdom.** Under this substantial small business guarantee scheme, which commenced in 1981, banks could lend up to £250,000[19] to eligible businesses and have 75% of any default losses met by the government. However, as the scheme matured, losses mounted. In 2004, the Graham Report[20] documented bad debt losses of approximately 20%.

   However, an ex post review published in 2010 commissioned by SFLG concluded that it had been highly successful, with a substantial amount of additionality and that the positive effects of the "loans obtained in 2006 show the overall benefits outweigh the cost to the economy in terms of [gross value added] GVA."[21] The report did not fully analyze the cost of the defaults of the scheme against the purported benefits.

   In 2009, SFLG was replaced by the Enterprise Finance Guarantee scheme, which increased the size of eligible loans to £1 million. However, only 3 years later, an investigation by The Guardian concluded that the scheme had misused over £200 million ($300 million) of the funds that had been used for the guarantees.[23] Further investigations reached similar conclusions,[24] and there were reports that the scheme was being investigated by public prosecutors for misuse of funds by the banks.

2. **The United States Small Business Administration Loan Guarantee Program.** This is the largest guarantee fund in the world, guaranteeing about $16 billion per year. A review of the scheme concluded that "[t]he average sales and employment numbers suggest that financing did not give a big boost to firms in terms of level of sales or employment; in most cases, a greater increase was found in the prefinancing years than in the post-financing years."[25] Further, although heralded in some circles, the $16 billion of Small Business Administration loans per year need to be seen in the context of the more than $1 trillion new credit granted to the private sector annually in the United States.

   The experience with the loan guarantee programs in the United Kingdom and in the United States reinforces the point made above regarding the difficulty and cost of monitoring such programs. Close monitoring results in high transactions costs for guarantee schemes, which frequently compromise their sustainability, as the example of Columbia illustrates.

19 Approximately $400,000.

20 T. Graham. 2004. *Graham Review of the Small Firms Loan Guarantee*. HM Treasury. 4 October. http://webarchive.nationalarchives.gov.uk/20130129110402/http://www.hm-treasury.gov.uk/graham.

21 M. Cowling. 2010. *Economic Evaluation of the Small Firms Loan Guarantee (SFLG) Scheme*. London: Department for Business Innovation and Skills.

22 I. Griffiths. 2013. Small firms loans scheme "misused by banks." *The Guardian*. 24 February. https://www.theguardian.com/business/2013/feb/24/small-firms-loans-scheme-misused

23 S. Ring and R. Partington. 2014. U.K. Banks Said to Be Probed Over Government Loan Program. Bloomberg. 18 August. http://www.bloomberg.com/news/articles/2014-08-18/sfo-said-to-probe-u-k-banks-on-lending-guarantee-abuse-claims

24 The Urban Institute. 2008. *Key Findings from the Evaluation of the Small Business Administration' Loan Guarantee Program*. Washington, DC.

However, the experience of the schemes in the United Kingdom and in the United States, as well as in the Pacific, illustrates that, without close monitoring, there is tendency for financial institutions to take advantage of loopholes or lack of oversight. These factors would weigh especially heavily in the Pacific, where capacity for close monitoring is limited.

6. TRADE CREDIT AND BUSINESS ENVIRONMENT REFORM FOR SMALL AND MEDIUM-SIZED ENTERPRISES

Credit guarantees are often proposed as a solution to the difficulty SMEs have in accessing finance in the Pacific. Any associated policy discussion needs to be clear on the policy objective behind the proposed support, and whether a guarantee on lending is the appropriate way to meet this objective.

Lending to SMEs is inherently risky. Reducing risk to lenders is the primary reason for the interest in guarantees. Banks often cite risk aversion, poor business practices, and a lack of financial information as reasons for their reluctance to lend. The fundamental reason why lending to SMEs is risky is that small businesses fail in large numbers, with the failure for start-ups being particularly high. While it is true that SMEs create large numbers of jobs, the durability of this employment growth is not assured, given that SMEs also close down in disproportionate numbers. The net contribution to employment and growth is often, therefore, small.

Pacific SMEs are no different and the lessons learned elsewhere apply in the region. SMEs everywhere struggle to fund their businesses. Lenders in high-income countries also do not readily provide funding for some of the same reasons that lenders in the Pacific refuse to lend to SMEs. Similarly, for funding start-ups, which are often given as justification for guarantees, it is rare even in high-income countries for commercial lenders to fund new businesses. The typical sources of new business finance are savings, investments from friends and family, and, in some cases, investments from "angel" investors. There is a good business reason for commercial banks not to fund start-ups, so guarantees should not try to address a perceived market failure that does not really exist.

BUSINESS ENVIRONMENT REFORM AND SMALL AND MEDIUM-SIZED ENTERPRISES

The implication of the previous discussion is that the main economic benefits accrue from the growth of individual SMEs—from a small to a larger business with the consequent employment and growth impacts—and that any assistance is best directed to those firms that will grow, as opposed to all SMEs, or those that are struggling. The policy implication is that government intervention should be directed toward removing broad constraints to business growth through business environment reform and the development of financing instruments suited to the typical balance sheet structures of SMEs. A policy that targets providing early-stage small businesses with credit guarantees risks losing a significant portion of the guaranteed funds.

From this perspective, SME policy differs in no essential way from more general business environment policy. One of the best explanations of this point is by Hallberg in her evaluation of the World Bank's SME policy:[25]

[25] K. Hallberg. 2000. *A Market Oriented Strategy for Small and Medium Scale Enterprises*. Washington, DC: World Bank.

> Many of the often-repeated justifications for scale-based enterprise promotion have little empirical support. But whether their actions are based on myth or reality, governments in both developing and industrialized countries do intervene to promote SMEs. Their SME assistance strategies often try to achieve a combination of equity objectives (alleviating poverty and addressing social, ethnic, and gender inequalities) and efficiency objectives (raising the productivity and profitability of firms). The confusion created by multiple objectives often leads governments to over-subsidize services that could be provided by the market. Direct provision of credit and nonfinancial assistance to SMEs tend to substitute for markets rather than deal with the underlying causes of market underdevelopment.

Thus, a guiding principle for effective financial market development is that the reform of the business environment is paramount. Hallberg sums up the issue well:

> This report suggests that the overall business environment is the most important determinant of SME competitiveness and growth, as well as a necessary condition for the success of targeted assistance programs. Necessary reforms to improve the business environment go beyond macroeconomic and structural adjustment to the alleviation of microeconomic and institutional constraints that discriminate against small firms and reduce their growth and competitiveness.

With respect to the means of financing that are consistent with financial market development, the importance of secured transactions reforms has been emphasized. In addition, a greater use of nonbank financing instruments, such as trade credit, would significantly alleviate the access to finance constraint that businesses face in the Pacific.

TRADE CREDIT: PART OF THE SOLUTION TO INCREASING BUSINESS FINANCE

Effective financial systems intermediate between savers and borrowers. On the savings side, this is done through financial institutions that can safely and effectively hold savings and pay interest on those balances. On the lending side, financial institutions provide credit to investors and consumers to enable them either to invest in projects that will bring future returns, or finance consumption. For economies to grow, financial institutions need to focus on longer term, business orientated investments.

However, it is not only financial institutions that have the potential to extend credit. Businesses themselves can do so and, in advanced economies, this type of credit, known as trade credit, plays a crucial role in business financing. It arises when suppliers deliver goods and services to their customers on credit terms, only requiring payment 15, 30, or 60 days after delivery. Essentially, this amounts to short-term financing of their customers, and the financing differs from bank credit in three ways:

- Suppliers are not lending cash, but are financing the purchase of the goods or services that they have supplied—they are lending goods and services.
- There is rarely a formal loan contract involved beyond the terms that are listed on the invoice.
- Suppliers are not part of the finance sector.

Essentially, trade credit extends total credit advanced in an economy because, when suppliers give credit terms to their customers, their trade credit recipients can, in turn, provide credit down their supply line. This, therefore, "lengthens the credit chain."

The amounts involved are often large. One study of a sample of 48 countries found that about 20% of all non-equity investment is provided through trade credit.[26] Other studies also show the importance of trade credit. For example, the analysis of a sample of small firms' financial positions in Portugal revealed that trade credit exceeded other short-term credit, including that supplied by banks, by a factor of up to three.[27] Even large firms make extensive use of trade credit. A study of stock exchange-listed firms in the United States revealed that trade credit is their most important type of short-term debt, amounting to twice that of other short-term debt.[28]

Trade credit has several advantages for businesses in general, and for SMEs in particular:

- It serves as a substitute for bank credit for providing finance to credit-constrained businesses.
- Suppliers providing trade credit have, in general, a much better knowledge of their customers than do commercial banks. They, therefore, have an informational advantage over commercial lenders.
- "Accounts receivable" of suppliers comprise a significant portion of suppliers' balance sheets and, in financial systems where secured transactions reforms have occurred, these constitute a sound form of collateral.

However, anecdotal evidence suggests that trade credit is not widely used in Pacific island economies. This could be explained by the fact that nearly all businesses are credit constrained, so that even suppliers do not have the positive cash flow that would enable them to provide credit to their customers. Nevertheless, the potential for using trade credit financing in the region is high.

Trade credit also addresses a number of issues that commercial bank lenders cite for not providing finance.

- Suppliers know the businesses and the sectors that they are supplying, obviating a frequent caution offered by commercial banks that it is hard to know businesses and sectors because financial information is unavailable and sectoral knowledge is limited.
- Banks comment that collaterals such as plant and equipment are unattractive, because they are difficult to sell if they are repossessed. Trade suppliers do not have this problem and, frequently, do significant business in used equipment. For example, if an outboard motor supplier repossesses the motor, it will not have difficulty selling it.
- The accounts receivable of suppliers constitute a strong form of collateral, even in sectors such as agriculture, which can be

26 T. Beck, A. Demirguc-Kunt, and V. Maksimovic. 2008. Financing Patterns Around the World: Are Small Firms Different? *Journal of Financial Economics*. 89. pp. 467–487.

27 M. Giannetti. 2003. Do Better Institutions Mitigate Agency Problems? Evidence from Corporate Finance Choices. *Journal of Financial and Quantitative Analysis*. 38 (1). pp. 185–212.

28 R. Rajan and L. Zingales. 1995. What Do We Know about Capital Structure? Some Evidence from International Data. *The Journal of Finance*. 50 (5). pp. 1,421–1,460.

easily pledged in countries where secured transactions frameworks have been reformed. Accounts receivable can be collected. For example, if banks advance 60% of an outstanding trade credit book, they have a sound asset that can be realized in the event of default.

- Trade credit is a relatively simple form of collateral that can be used by development banks to provide credit to any sector.

Thus, promoting trade credit is central to financial market development in the region. It is well-suited to the financing needs of Pacific SMEs, and offers a powerful alternative to credit guarantees.

7. CONCLUSION

This paper has assessed the case for using credit guarantees as a means to increase access to credit in Pacific island countries. It reviewed the use of guarantees in the Pacific region and the wider international experience. Neither in the Pacific, nor in other parts of the world, can compelling examples of successful guarantee schemes be identified. Their popularity in the political arena is not matched by evidence of making a significant difference to credit access.

The paper also noted that there was no theoretical case for guarantees. The guarantee merely changes risk allocation, not the probability of default. Further, if a guarantee is correctly priced, then this price will reflect the probability of default and will be ultimately passed on to the borrower.

The analysis also points out that the difference that guarantees can make is at best marginal—the size of guarantees necessary to increase the ratio of private sector credit to gross domestic product by, say, 5 percentage points is too large for either donor- or government-sponsored guarantee schemes. Even if the impact on credit was more encouraging, it would still be difficult to justify the introduction of a guarantee scheme because implementing a well-designed scheme—that is, one that will have minimal losses, while increasing lending—is a demanding exercise. Issues that relate to sectoral targeting; the type of businesses to be supported; and the length of guarantee schemes, monitoring, and repossession in the event of default all need to be addressed.

Reforms of collateral frameworks of Pacific island economies that have been completed, or are in process, provide a powerful new instrument to promote lending in the region. The disappointing take-up by lenders to date does not detract from the longer-term potential of secured transactions reforms to substantially increase access to credit for businesses of all sizes. Similarly, increasing the use of trade credit would also substantially alleviate the constraint faced by businesses in accessing finance, and is a preferable alternative to guarantees.

Finally, the discussion highlighted the importance of business environment reform. Attempting to improve credit access in countries where it is extremely challenging to do business will have minimal lasting impact, without these reforms.

APPENDIX 1: LENDING AND PROFITABILITY INDICATORS FOR SEVEN PACIFIC COUNTRIES (AS OF 31 DECEMBER 2014)

Country	Ratio of Private Sector Credit to Gross Domestic Product (%)	Loan to Deposit Ratio of Commercial Banks (%)	Total Value of Loans to the Private Sector (millions of domestic currency units)	Broad Money (millions of domestic currency units)	Excess Liquidity[a] (%)	Return on Equity (%)
Fiji	62	83	5,264	6,318	7	26
Palau	13	17	32	...	...	...
Papua New Guinea	28	55	10,264	18,716	9	25
Samoa	41	105	830	818	10	11
Solomon Islands	21	47	1,703	3,635	27	15
Tonga	32	63	239	387	26	n.a.
Vanuatu	68	88	56,747	58,962	12	3

... = not available.

[a] Calculated as (total reserves – required reserves)/total assets.

Source: International Monetary Fund. International Financial Statistics. http://data.imf.org/?sk=5DABAFF2-C5AD-4D27-A175-1253419C02D1

APPENDIX 2: CREDIT GUARANTEE SCHEMES IN THE PACIFIC

Scheme	Fiji – SME Credit Guarantee Scheme
Implemented by	Reserve Bank of Fiji (RBF)
Funder	Government of Fiji (F$4 million seed capital; additional F$1.5 million allocated in 2016 National Budget)
Guarantee type	Any new small and medium-sized enterprise loan
Coverage ratio	50% of principal, up to F$50,000 per business
Loan amount/terms	Loan amount is not defined, as long as the loan is to businesses that fall within the definition of an SME Maximum interest rate on SME loan of 10% per year
Fee	None
Eligibility	Small enterprise (turnover/total assets F$30,000–F$100,000; 6–20 employees) Medium enterprise (turnover/total assets F$100,000–F$500,000; 21–50 employees) All sectors except sugar cane farmers and government-subsidized businesses
Financial institutions	Commercial banks, licensed credit institutions, and Fiji Development Bank
Established	2012
Rationale	To promote and develop the local business industry, improve private sector lending to SMEs, and stimulate growth
Payout conditions	Loan has been in arrears for at least 180 days and all reasonable steps have been taken to recover the debt
Further information	Guarantee applies to all new SME loans approved by financial institutions after 1 January 2012, subject to interest rate cap and eligibility criteria. Financial institutions must report monthly on all new SME loans covered through scheme. RBF Statistics (31 December 2014): 708 SME loans under scheme worth F$41.6 million.
Details	The Fiji SME Credit Guarantee Scheme is funded by the Government of Fiji and administered by the RBF. It was established in 2012. Its objective is to promote and develop the local business industry, improve private sector lending to SMEs, and stimulate growth. The government has allocated F$4 million ($1.9 million) seed capital through the national budget, with an additional allocation of F$1.5 million ($0.7 million) in the 2016 National Budget. The guarantee scheme applies to all new loans to SMEs by financial institutions (including commercial banks, licensed credit institutions, and the Fiji Development Bank) after 1 January 2012, subject to an interest rate cap (of 10% per annum) and eligibility criteria (all SMEs excluding the sugar cane industry, government-subsidized businesses, and property investment). Small enterprises are defined as those with turnover or total assets between F$30,000–F$100,000 ($14,100–$46,900) and 6–20 employees. Medium enterprises are defined as those with turnover or total assets between F$100,000–F$500,0000 ($46,900–$234,300) and 21–50 employees. The scheme covers 50% of the principal outstanding on defaulted loans up to a limit of F$50,000 ($23,400) per business. No guarantee fees are charged. To be covered under the scheme, financial institutions must submit monthly reports to RBF, which detail all new eligible SME loans. To claim on the guarantee, a loan must have been in arrears for 180 days and all reasonable steps must have been taken to recover the debt. The portfolio of loans covered increased from 187 SME loans valued at $10.7 million ($5 million) at end December 2012, to 460 SME loans valued at F$27.2 million ($12.7 million) at end December 2013, to 708 SME loans valued at F$41.6 million ($19.5 million) at end December 2014. The approximate average balance of loans covered under the scheme was F$57,200 ($26,800) at end December 2012; F$59,100 ($27,700) at end December 2013; and F$58,800 ($27,600) at end December 2014. RBF received no claims under the scheme in 2012 and 2013, and paid out one claim per year in 2014 and 2015. It is unclear whether the scheme has had an additionality effect (i.e., extra loans that would not have been written by financial institutions in the absence of a credit guarantee scheme).

SMEs = small and medium-sized enterprises.

Sources: Reserve Bank of Fiji. 2012. *Annual Report 2012*. Suva; Reserve Bank of Fiji. 2013. *Annual Report 2013*. Suva; Reserve Bank of Fiji. 2014. *Annual Report 2014*. Suva; and Reserve Bank of Fiji. 2015. *Small and Medium Enterprises Credit Guarantee Scheme Guidelines*. Suva.

Scheme	Papua New Guinea – Risk Share Facility (World Bank Group)
Implemented by	International Finance Corporation (IFC)
Funders	World Bank Group (International Development Association [IDA]/IFC), and Government of Papua New Guinea (PNG)
Guarantee type	Portfolio (newly originated loans only)
Coverage ratio	50% (10% first-loss cover IDA, 40% second-loss cover IFC on commercial terms)
Loan amount/terms	K50,000 up to K1.5 million; commercial interest rate; term of 12–72 months
Fee	Commercial
Eligibility	Formerly registered PNG firms (including landowner companies) or joint ventures with a maximum annual turnover of K15 million. Existing and start-up SMEs.
Financial institutions	Bank South Pacific (BSP); other financial institutions may join, subject to due diligence and performance criteria. Eligibility criteria include minimum shareholder equity, portfolio of SME loans, return on average equity, return on average assets, and maximum nonperforming loan ratio.
Established	2011
Rationale	To support and encourage eligible local private sector commercial banks and finance companies to expand lending and leasing finance to SMEs, as one of the factors that contribute to limited SME access to financial services in PNG is a lack of up-to-date knowledge and expertise within financial institutions.
Payout conditions	Not applicable
Further information	BSP portfolio can grow up to $50 million (K150 million). Up-front capitalization (disbursement of IDA funds) to IFC reserve account to enhance credibility of IFC as guarantor Complementary technical assistance to BSP, borrowers, and government's Department of Commerce and Industry ($4.5 million total) As at 30 June 2015, with a portfolio of K51 million with 1,304 new loans For capital adequacy purposes, the IFC guarantee carries a risk weight of 20%

continued on next page

Table *continued*

Scheme	Papua New Guinea – Risk Share Facility (World Bank Group)
Details	The World Bank Group's Risk Share Facility (RSF) in PNG was established in 2011 under the Small and Medium Enterprise Access to Finance Project. It is funded by the Government of PNG (through IDA credit) and the IFC, and is administered by the IFC. In addition to the RSF, the World Bank project provides technical assistance to borrowers, financial institutions, and the government's Department of Commerce and Industry. The project aims to encourage commercial banks and finance companies to expand lending and leasing finance to SMEs. The RSF guarantees 50% of principal losses in portfolios of new eligible SME loans by participating financial institutions. Loans of K50,000–K1.5 million ($16,800–$502,600) at commercial interest rates with a term of 12–72 months are eligible, provided the borrower is a formally registered PNG firm or joint venture. There are no sector limits. First-loss cover of 10% is provided through IDA funding, and second-loss cover of 40% by IFC (i.e., while IFC pays participating financial institutions up to 50% of principal losses in the portfolio, the first 10% of principal losses in the portfolio will be reimbursed to IFC by IDA). Participating financial institutions are charged an undisclosed commercial guarantee fee by IFC. BSP is now the only participating financial institution. Other financial institutions may join, subject to due diligence and performance criteria. The World Bank's design documents state that loans to both existing businesses and start-ups are eligible, but BSP has stated that the facility will only cover loans for the expansion of existing businesses, not new business start-ups. At design, it was estimated that the total size of the RSF would be K300 million (now $100 million). BSP was allocated 50%, whereby its covered portfolio could grow to K150 million ($50 million), with the remainder to be allocated to other financial institutions. BSP's committed RSF portfolio totaled K25 million ($8.4 million) and 231 loans at end September 2013; K43 million ($14.4 million) and 653 loans at end June 2014; and K51 million ($17.1 million) and 1,304 loans at end June 2015. In July 2013, BSP announced that it had made SME loans and advances covered by the RSF of around K16 million ($6 million), compared with BSP's overall lending to SMEs in excess of K480 million ($178.9 million). It is unclear how BSP determines for which subset of new SME loans it will seek RSF cover. RSF uptake has been slower than forecast by the World Bank Group during design. There is no publicly available information on sector exposure, portfolio arrears, or guarantee calls.

IDA = International Development Association, SMEs = small and medium-sized enterprises.

Sources: World Bank. 2011. *International Development Association Project Appraisal Document on a Proposed Credit in the Amount of SDR 13.73 Million (US$21.91 Million Equivalent) to the Independent State of Papua New Guinea for Small and Medium Enterprise Access to Finance Project*. Washington, DC; and World Bank. 2015. *Papua New Guinea Small and Medium Enterprise Access to Finance Project (P120707): Implementation Status and Results Report: Sequence 08*. Washington, DC.

Scheme	Papua New Guinea – Risk Share Facility (Asian Development Bank)
Implemented by	AFC Consultants – operation of the risk share facility (RSF) Bank of PNG – issues guarantee and hosts trust account where capitalized fund is held Board of Trustees – Asian Development Bank (ADB) / Bank of PNG / Department of Treasury
Funders	ADB and Government of PNG through Microfinance Expansion Project (seed capital of $5 million)
Guarantee type	Portfolio
Coverage ratio	50% of final losses of principal
Loan amount/terms	Micro and small-sized enterprise (MSE) loans not exceeding K100,000 per obligor
Fee	1% for loans with a term up 12 months, then an increment of 0.05% per additional month of the loan term is applied. The maximum fee is 2.2% (maximum loan term of 36 months).
Eligibility	MSEs (natural persons or small incorporated businesses or informal businesses)
Financial institutions	Commercial banks, microbanks, savings and loans societies, and finance companies
Established	June 2014
Rationale	To address market failure in the perceived credit risk of the MSE sector
Payout conditions	Principal losses in eligible covered portfolios after offset of cash collateral and liquidation of other moveable assets/securities at the rate of 50% of residual losses
Further information	The Department of Treasury is the formal implementing agency of the RSF. The Bank of PNG acts as an agent of the Department of Treasury in issuing the guarantee. A contracted fund manager is responsible for the day-to-day management of the RSF. Participating financial institutions sign a Portfolio Risk Sharing Agreement with the Bank of PNG, which defines the loans to be covered up to a preagreed quota. All loans issued by the financial institution that meet the criteria automatically fall within the guarantee issued. The RSF is funded through the ADB loan to the Government of PNG for the Microfinance Expansion Project.
Details	ADB's PNG Microfinance Expansion Project set up an RSF in 2014, funded with $5.1 million seed capital drawn from an ADB loan to the Government of PNG. The capital was placed in a trust account domiciled with the Bank of PNG, which also serves as the guarantor, and executes risk share agreements with participating financial institutions. A contracted fund manager is responsible for the day-to-day management of the RSF, including due diligence of prospective participating financial institutions. A Board of Trustees provides oversight. The RSF covers 50% of materialized principal losses after offset of cash collateral and liquidation of available collateral and sureties. It applies to portfolios of loans to MSEs (including natural persons) not exceeding K100,000 per loan/obligor and with a maximum term of 36 months by approved financial institutions. Loans to both start-ups and existing enterprises qualify. Commercial banks, microbanks, savings and loan societies, and finance companies are eligible to join, subject to due diligence. Participating financial institutions sign a portfolio risk-sharing agreement with the Bank of PNG, which defines the products to be covered, up to a preagreed quota. All loans issued that meet the criteria automatically fall within the guarantee issued. A one-time guarantee fee based on the loan term and of ranging from 1% to 2.2% of the principal disbursed is charged upfront. The RSF is currently fully operationalized, and due diligence of four financial institutions have been finalized and approved by the board. Three risk-sharing agreements have been signed and implemented as of end 2015. The fourth risk-sharing agreement is expected to be signed by early 2016. It is too early to draw lessons from the RSF. However, it is noted that the operating model relies on the services of a contracted fund manager. This overcomes potential issues around implementation capacity, but will cost an estimated $1.4 million in management fees over a 5-year period, drawn from the ADB loan. Further, as the total potential losses of the RSF may not exceed the seed capital, the potential outstanding portfolios covered are restricted to approximately $10 million (in kina equivalent).

PNG = Papua New Guinea, RSF = Risk Share Facility.

Source: ADB. 2013. *Papua New Guinea Microfinance Expansion Project: Establishment of the Risk Share Facility Mission Report and Draft Structuring Document*. Manila. (Loan 2686–PNG, consultant's report).

Scheme	Papua New Guinea – Small Business Credit Guarantee Scheme
Implemented by	Small Business Development Corporation (SBDC)
Funder	Government of Papua New Guinea (PNG)
Guarantee type	Individual
Coverage ratio	80%
Loan amount/terms	K5,000–K20,000 small guarantee, K21,000–K60,000 medium and large guarantee
Fee	1% of the guaranteed portion of the principal
Eligibility	100% nationally owned small businesses in manufacturing, processing, agribusiness, and professional services
Financial institution	National Development Bank
Established	Various times since 1970s – most recently in 2006
Rationale	To assist and kick-start small businesses that lack sufficient security, and erase their financial constraints by extending credit to aspiring national entrepreneurs
Payout conditions	Not applicable
Further information	100 SME accounts between 2005 and 2014, worth $1.5 million – 60% default rate Scheme launched in 1996: Asian Development Bank and the Government of PNG—initial capitalization of K8 million. Coverage of 50%–80% for loans of K1,000– K100,000. No more than 30 loans.
Details	The SBDC established the PNG Small Business Credit Guarantee Scheme in 2006 with funding from the Government of PNG. The scheme aims to increase access to credit by small enterprises that lack sufficient collateral. The scheme guarantees up to 80% of the principal of loans of K5,000–K60,000 ($1,650–$19,800) to small businesses that are wholly owned by indigenous or naturalized citizens of PNG. Formal and informal businesses are eligible, and loans can be for start-ups or expansion of existing businesses. Businesses appear to be selected by the SBDC and loan proposals are forwarded to participating financial institutions. It seems that borrowers are required to provide cash collateral, so that participating financial institutions effectively bear no principal risk. SBDC signed agreements with the Rural Development Bank (now the National Development Bank) for at least K1 million ($0.4 million), and with the Australia and New Zealand Banking group Limited (ANZ) for at least K0.5 million ($0.2 million) in 2007/2008. Committed funds were transferred upfront to participating financial institutions to cover future principal losses. It is unclear whether agreements were signed with other financial institutions.In 2014, a representative of SBDC presented an overview of the scheme at a conference. It was reported that about 100 small and medium-enterprise loans had been guaranteed to the value of $1.5 million since 2005. This suggests an average loan size of $15,000. The reported default rate was 60%.

Sources: N. Timo. 2014. Presentation at the 24th Annual Training Programme of the Asian Credit Supplementation Institution Confederation. Republic of Korea. August; and National Development Bank. 2012. *General Information Brochure: Small Business Credit Guarantee Scheme*. https://ndbpng.files.wordpress.com/2012/02/sbdc.pdf

Scheme	Samoa – Small Business Loan Guarantee Scheme
Implemented by	Small Business Enterprise Centre (SBEC)
Funders	New Zealand Aid Programme (ST600,000)/Government of Samoa (ST9 million – ADB loan)
Guarantee type	Individual
Coverage ratio	80% of principal (100% for loans up to ST10,000 pilot)
Loan amount/terms	Loans up to ST50,000 (ST1,000–ST20,000 first time applicants, subsequently to ST50,000)
Fee	Originally 2.5%–5.0% depending on loan amount
Eligibility	Businesses must have completed SBEC training for business management
Financial institutions	Development Bank of Samoa and all four commercial banks (ANZ, Bank South Pacific, National Bank of Samoa, Samoa Commercial Bank)
Established	1995 (New Zealand) and 2002 (ADB)
Rationale	To facilitate access to finance for small businesses in Samoa that lack the collateral required for loans.
Payout conditions	Under the ADB project, if a loan had been in arrears for 90 days and the bank called on the guarantee, and if neither the SBEC nor the bank could salvage the account, the SBEC had to provide a proposal for loan foreclosure to the Ministry of Finance. In turn, the Ministry of Finance will evaluate the proposal and inform the SBEC of its decision within 7 days. The funds were held by the Central Bank of Samoa as term deposits in commercial banks. If the Ministry of Finance agrees with the SBEC assessment and proposals for payment, it will endorse the account to the Central Bank of Samoa for payment of the guarantee.
Further information	October 2011: 1,377 clients, ST22.5 million in loans, ST16.4 million guaranteed, ST2.1 million paid out, ST6.1 million guarantees cleared—13% claims paid, 37% cleared guarantees 61% of loans between ST5,000 and ST20,000, 38% of loans over ST20,000

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Table *continued*

Scheme	Samoa – Small Business Loan Guarantee Scheme
Details	The Samoa Small Business Loan Guarantee Scheme is administered and managed by the SBEC. It was established in 1995 with seed funding from the New Zealand Aid Programme (ST600,000; $231,200) and expanded in 2002 through an ADB loan to the Government of Samoa for the Small Business Development Project (ST9 million; $3.5 million). Its objective is to facilitate access to finance for small businesses that lack the collateral required for loans. The scheme covers individual loans up to ST50,000 ($19,300) to businesses by the Development Bank of Samoa and all four commercial banks in Samoa. It typically guarantees up to 80% of the loan principal, while borrowers are required to secure a private guarantee or put up a term deposit to cover the remaining 20%. For loans of up to ST10,000 ($3,900) a 100% loan guarantee is offered. The SBEC plays a significant role in loan origination, appraisal, and monitoring. Loans are granted for starting capital for new businesses and for working capital for existing businesses. ADB's Independent Evaluation Department reviewed the scheme in 2011. It found that 838 guarantees were issued from 2002 to 2008 for ST11.6 million ($4.5 million) covering loans totaling ST15.8 million ($6.1 million). The average loan value was ST18,850 ($7,300). As of 30 September 2010, 6% of guarantees had been paid out. A further 33% of current loans were in arrears, with arrears representing 8.5% of current loan balances (note: part of principal in arrears only, not total principal of loans in arrears). It conducted a survey of 100 recipients of guaranteed loans, and found that 93% of sample businesses were sole proprietors. The survey also found that 39% of sample businesses were engaged in services; 38% in commerce, trade, or retail; 11% in manufacturing; and 2% in fishing. In 2011, the SBEC reported that a total of 1,377 guarantees had been issued for ST16.4 million ($6.3 million) covering loans totaling ST22.5 million ($8.7 million). Foreclosures amounted to ST2.1 million ($0.8 million) and ST6.1 million ($2.4 million) of guarantees was cleared, leaving ST8.2 million ($3.2 million) in guarantees outstanding. 1% of guarantees were issued for loans of <ST5,000 (<$1,900); 61% for loans of ST5,000–ST20,000 ($1,900–$7,700); 38% for loans of >ST20,000 (>$7,700). ADB's evaluation in 2011 found that the scheme had some success in increasing access to finance for target businesses. However, there had been insufficient incentive for the banks to be diligent in loan appraisal, monitoring, and collection, given the high coverage ratio and reliance on SBEC for loan appraisal and monitoring. This created moral hazard and resulted in a high level of arrears and foreclosures. Further, delays in payments of claims on the guarantee due to complex processes reduced bank interest in the scheme.

ADB = Asian Development Bank, ANZ = Australia and New Zealand Banking Group Limited.

Sources: ADB. 2011. *Performance Evaluation Report: Small Business Development Project in Samoa*. Manila; Government of Samoa, Ministry of Commerce, Industry and Labour. 2014. *Directory for Technical and Financial Assistance to the Private Sector of Samoa*. Apia; and M. Malua. 2011. Access to Finance for Small Business in Samoa: The Small Business Enterprise Centre (SBEC). Presentation at UNCTAD Pacific Regional Capacity Building Workshop on Enhancing Access to Finance for the Agricultural Sector. Nadi. 21 October.

Scheme	Samoa – AgriBusiness Support Project
Implemented by	Commercial banks
Funders	ADB AgriBusiness Support Project – grant to the Government of Samoa ($5 million)
Guarantee type	Individual
Coverage ratio	50% of principal for first loan, 30% for second loan
Loan amount/terms	Loans up to $750,000, maximum 7-year tenor
Fee	None (interest rate paid on cash collateral deposited with bank)
Eligibility	Enterprises in the agriculture or agribusiness sector
Financial institutions	ANZ (40%), BSP (40%), Samoa Commercial Bank (20%), National Bank of Samoa (10%)
Established	Approved 2014, operational since 2015
Rationale	To address enterprises' insufficient collateral and banks' risk aversion
Payout conditions	ADB project's facility manager involved in due diligence (to identify business development service requirements) and monitoring Allocation made to commercial banks—cash collateral provided The project also has a "supplementary seed capital" component for selected businesses; normal bank recovery procedures. Claimed amount can be withdrawn from cash collateral held by the bank 8 weeks after loan became overdue and if all recovery avenues have been exhausted.
Details	ADB's AgriBusiness Support Project, which was approved in 2014, aims to increase access to finance for commercial agribusinesses in Samoa. The project provides up to $3 million to financial institutions as: Cash collateral for loans to selected agribusinesses ($2 million). Coverage is provided for up to 50% of the principal of first-time loans of up to $750,000 with a maximum tenor of 7 years. Second-time loans are covered at 30% of the principal. Participating financial institutions receive an allocation of project funds as a deposit. The participating financial institutions make independent credit decisions, although the project's facility manager participates in due diligence. There is a predefined process which allows the financial institution to recover the covered proportion of repayment arrears of eligible loans directly from the deposit held; Supplemental seed capital ($1 million). Participating financial institutions receive a project allocation, which they can provide to agribusinesses as an interest-free capital injection, repayable in a single payment with a maximum term of 7 years. The allocation per agribusiness is limited to $100,000 or 25% of the enterprise's financing plan. Since the AgriBusiness Support Project was approved in 2014, agreements have been signed with ANZ and Westpac, allocating $1.2 million to each bank—$800,000 for cash collateral for loans to selected agribusinesses and $400,000 for supplemental seed capital. Westpac sold its entity to BSP in August 2015. No further information is available on take-up at this time.

ADB = Asian Development Bank, ANZ = Australia and New Zealand Banking Group Limited, BSP = Bank South Pacific.

Sources: ADB. 2014a. *Report and Recommendation of the President to the Board of Directors: Proposed Grant to the Independent State of Samoa for the Samoa AgriBusiness Support Project*. Manila.

Scheme	Solomon Islands – Small Business Finance Scheme
Implemented by	Central Bank of Solomon Islands (CBSI)
Funders	CBSI / Government of Solomon Islands (SI$10 million seed capital)
Guarantee type	Individual loans
Coverage ratio	90% of the unsecured portion of a bank loan to a maximum guarantee of SI$300,000 (previously 80% and maximum guarantee of SI$200,000)
Loan amount/terms	SI$50,000–SI$1 million, maximum term of 5 years (previously SI$5,000–SI$250,000)
Fee	1% flat of the amount of the loan
Eligibility	Business loans for business development; all sectors with emphasis on SMEs involved with rural or export business ventures; not overdrafts. Borrower must contribute at least 20% of total project cost. Individual Solomon Islanders, companies, or cooperatives owned and controlled by Solomon Islanders, and joint ventures between Solomon Islanders and foreigners provided that Solomon Islanders own at least 50% of share capital.
Financial institutions	Commercial banks (finance companies/credit unions excluded)
Established	2007 (roll out from August 2008)
Rationale	To encourage licensed commercial banks to give more support to the SME sector by providing additional collateral to a bank to enable it to lend to those SMEs which the bank regards as creditworthy, but which are unable to provide collateral security to the level required by the bank.
Payout conditions	Recovery procedures for specific bank applies. The bank initiates legal action when the loan becomes nonperforming, and submits a claim if the loan remains in default for more than 90 days after a court judgment has been obtained.
Number of guaranteed loans	At the end of 2012, 55 loans were approved (36 current, 9 claims processed and paid to banks as a result of defaults, and 10 guarantees cancelled as loans had been fully serviced). In 2013, only four loans were approved for guarantee and, in 2014, only five, taking the total of individual loan approvals over the life of the scheme to 64.
Details	The Solomon Islands Small Business Finance Scheme is funded by the Government of Solomon Islands and administered by CBSI. It was formally established in 2007 and rolled out in 2008. Its objective is to encourage commercial banks to support the SME sector, by providing security for loans to SMEs, which the bank regards as creditworthy but unable to provide adequate security. The government allocated SI$10 million ($1.3 million) seed capital through the national budget. The scheme now covers 90% of the unsecured portion of bank loans of SI$50,000–SI$1 million ($6,200–$123,700) with a maximum term of 5 years, and up to a maximum guaranteed amount of SI$300,000 ($37,100) per loan. Previously, it covered 80% of the unsecured portion of bank loans of SI$5,000–SI$250,000 ($600–$30,900). Only commercial banks are eligible to participate. Finance companies are excluded. Loans for business development in all sectors are eligible, with an emphasis on SMEs involved with rural or export business ventures. Loans to individuals, companies, and cooperatives are eligible. The scheme focuses on business expansion, although start-ups do not appear to be excluded. A flat fee of 1% of the loan principal is charged. Individual loans are nominated by the commercial banks for inclusion in the scheme, and a separate guarantee agreement is entered into between the commercial bank and CBSI for each guaranteed loan. In the case of default, the bank must use its usual recovery procedures. The bank is expected to initiate legal action, and only after the loan remains in default for more than 90 days after a court judgment has been obtained can the bank submit a claim to CBSI. CBSI reports that 59 loans were approved for inclusion under the scheme from 2008 to 2013. As at end December 2012, 55 loans had been approved, of which 36 were current (65%), 9 had defaulted and had claims paid out to banks (16%), and 10 loans had been fully repaid and the guarantee cleared (18%). As at end December 2012, the net guaranteed portfolio was SI$3.95 million ($490,000), equivalent to a guaranteed residual amount of about SI$110,000 ($13,600) per current loan.

SMEs = small and medium-sized enterprises.

Sources: Central Bank of Solomon Islands. Small Business Finance Scheme Pamphlet. Unpublished; Central Bank of Solomon Islands. 2007. *Small Business Finance Scheme Guidelines for Working with Partner Banks*. Honiara; Central Bank of Solomon Islands. 2013. *CBSI 2012 Annual Report*. Honiara; Central Bank of Solomon Islands. 2014. *CBSI 2013 Annual Report*. Honiara; and Central Bank of Solomon Islands. 2015. *CBSI 2014 Annual Report*. Honiara.

OTHER PACIFIC CREDIT GUARANTEE SCHEMES

Federated States of Micronesia – Pohnpei	The Small Business Guarantee and Finance Corporation was established as a corporate body pursuant to the Business Development Act 1994. Its loan guarantee program was suspended due to legal and technical issues surrounding the guarantee agreement in 2005.
Details	As of May 2008, 75 loans with a value of $1.1 million had been guaranteed, averaging around $15,000 per loan.

Source: Small Business Guarantee and Finance Corporation. 2008. Presentation at Executive Retreat 2008. http://www.comfsm.fm/national/administration/VPA/researchdocs/psgrsite/SBGFC.ppt

Kiribati	The Small Enterprise Development Act 2001 established the Small Enterprise Guarantee Corporation with the purpose of establishing a loan and lease guarantee scheme for eligible small enterprises. It had A$1 million in total capital, including A$0.5 million from the government and A$0.5 million in investments from other public and/or private sources. A 2012 government forum recommended the "review of the Small Enterprise Guarantee Corporation (SECG) Scheme with the possibility of establishment using the best practices and experiences in other Pacific Countries."

Source: Government of Kiribati. 2012. Agenda Item 4: Private Sector Development Priority Issues in Kiribati. Prepared for the Development Partner's Forum. Tarawa. 25–27 June.

Papua New Guinea	The Papua New Guinea Credit Guarantee Scheme is administered by the Department of Finance. It was first established in 1976 and was operational until at least 1998. Institutions included Papua New Guinea Banking Corporation, Westpac, Australia and New Zealand Banking Group Limited, and Bank South Pacific. It provided coverage of 80% of principal and interest. It covered individual loans of up to K50,000 and group/company/joint venture loans from K50,000 to K200,000 provided there were at least to five national shareholders. A lack of budgetary support from the government and delays in payment of claims resulted in a lack of trust between the banks and the government. According to Kavanamur, the Department of Treasury accused banks of failing to properly monitor and supervise loans under the scheme, and of calling upon the guarantee without fully exhausting loan recovery processes.

Source: D. Kavanamur. 2003. Re-positioning non-bank service strategy in Papua New Guinea. *Journal of Labour and Management in Development*. 3 (6). pp. 1–24.

Papua New Guinea	Various credit guarantee schemes with members of Parliament and local district administrations to increase access to finance in an electorate/district. For example, Anglimp South Waghi Credit Scheme—K1 million seed capital to National Development Bank private sources – 6.5% interest rate, 10% cash security, minimum K1,000/maximum K3,000 per business or individual

Source: National Development Bank of Papua New Guinea. Anglimp South Waghi Credit Scheme. https://mobile.facebook.com/story.php?story_fbid=609355005797948&substory_index=0&id=225040604229392

Papua New Guinea	A Small Business Credit Guarantee Scheme administered by the Small Business Development Corporation (SBDC) was launched with seed capital of K1.6 million (then about $1.3 million) provided by the Government of PNG in 1996. Coverage ranged from 50% to 100% of principal of loans from K1,000 to K100,000 (then $780–$77,000) by participating financial institutions. Guarantee funds were placed on term deposit with the participating financial institutions. According to a paper by David Kavanamur from 2003, the actual number of loans disbursed under the scheme was no more than 30, the default rate was high, and participating institutions simply called on the guarantee without exhausting loan recovery processes. The banks were found to be very risk-averse, despite often facing no principal risk, while SBDC lacked the resources and expertise to support an effective scheme.

Source: D. Kavanamur. 2003. Re-positioning non-bank service strategy in Papua New Guinea. *Journal of Labour and Management in Development*. 3 (6). pp. 1–24.

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Credit Guarantees

Challenging Their Role in Improving Access to Finance in the Pacific Region

The Pacific Private Sector Development Initiative—a regional technical assistance facility cofinanced by the Asian Development Bank (ADB), the Government of Australia, and the Government of New Zealand—has undertaken landmark secured transaction reforms in eight Pacific Island countries. These reforms have unlocked the value in "movable" assets such as machinery, inventory, and accounts receivable for use as collateral in borrowing. They have the potential to benefit businesses and financial institutions that offer business loans.

Yet, despite these reforms, financial institutions remain unwilling to lend. Businesses still find it hard to access the credit they need to grow, which in turn creates jobs and drives the economic activity so desperately needed in the Pacific. Credit guarantees are often proposed as an instrument to overcome this problem. However, as this publication demonstrates, there is no strong theoretical justification for their use.

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