MICROFINANCE AND CREDIT GUARANTEE SCHEMES - EXPERIENCES IN THE ECONOMIES IN TRANSITION

by

Dr. Antal Szabó
Retired UNECE Regional Adviser on Entrepreneurship and SMEs
Scientific Director of the ERENET Network

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INTRODUCTION

Financing SMEs especially in Countries in Transition (CITs) is one of the major burdens of entrepreneurship development. Among the major problems for SMEs in CITs is securing the initial capital necessary for access to initial credit so that potential entrepreneurs can start their operations. In general, European SMEs are heavily reliant on bank credit as external finance Small enterprises often face difficulties when they approach finance providers for both investment and working capital as banks often perceive microcredit as a high risk and low return activity and the high handling cost for micro-loans. Access to finance is more business constrain for small firms rather than medium-sized enterprises.

Every year, some 2.5 million enterprises are created in the UNECE region, 90% of which are micro-enterprises with less than 5 employees. In the EU, some 30% of new enterprises do not survive more than 3 years and some 50% less than 5 years. In CITs no data is available on this issue.

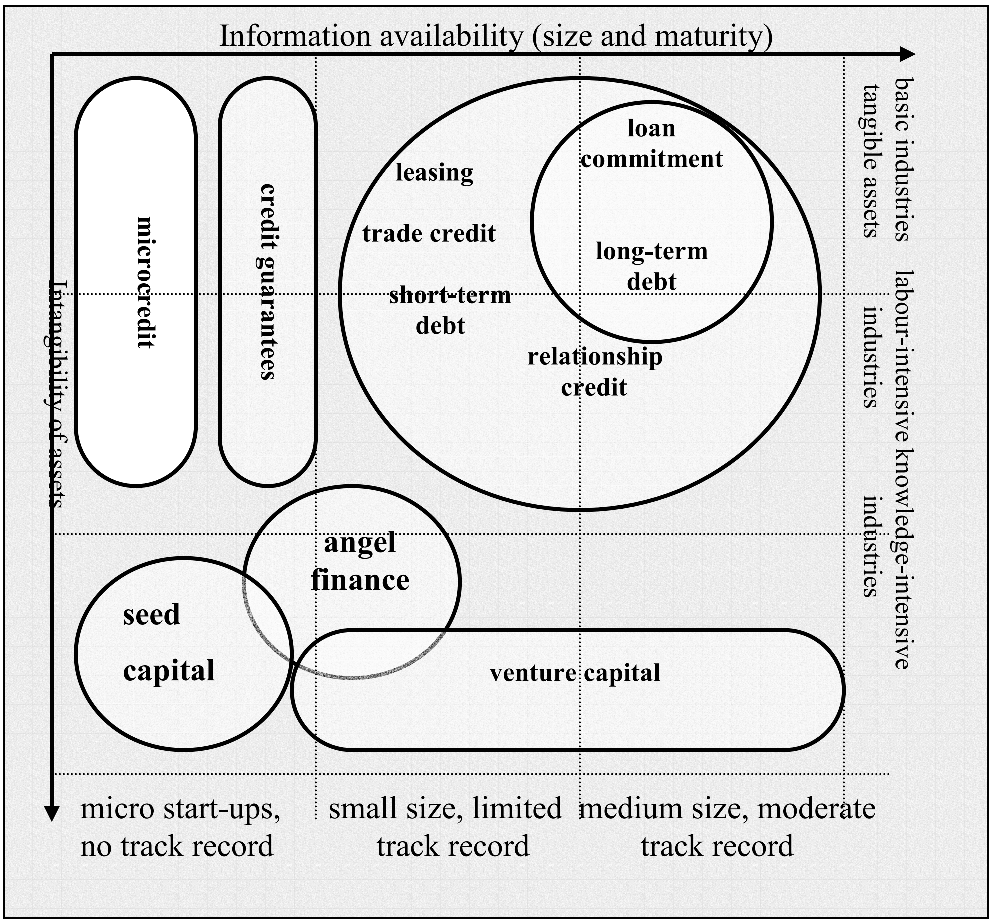
Insufficient supply of microloans is a major issue, and particularly affects start up businesses and those, who are unemployed, women or people who form part of an ethnic minority. Supporting microloan supply is therefore not only an issue of entrepreneurship and economic growth, but also of social inclusion.

Entrepreneurs in most CITs commonly identify heavy and frequently changing tax burdens on SMEs as one of the most important impediments to their operation and success. Many entrepreneurs escape into the shadow economy, which is estimated at between 20 to 40 per cent of GDP in CITs. Governments should develop transparent, stable and predictable taxation system and also create favourable condition in order to encourage "informal" entrepreneurs to became "formal" and create additional revenue for the state.

Preconditions for effective work in the financial support of SMEs include an enabling legal and regulatory environment for business, appropriate government policies, both for the SME sector and as regards general banking issues. Governments are encouraged to establish appropriate alternative financial schemes such as credit guarantee schemes, leasing, start-up credit scheme and equity facilitation.

FINANCIAL NEEDS FOR SMEs

Availability of financial instruments is of paramount importance for SMEs. Financial instruments are defined as any tools that are used by either firms or financial intermediaries to acquire or intermediate funds. There is a one important thumb-finger rule: different SME target group need various financial schemes and lines. These varied from microcredit through public credit guarantee fund and from multual credit guarantee association to venture capital and others. There is not a unique tool of financing SMEs. The need depends basically on the stage of maturity and size of an enterprises. The author of this paper with the assistance of a Finn doctorandus *Janne Sevanto* from the Tampere University of Technology constructed a stylised matrix in order to synthesise and illustrate differences in financial options heterogeneous SMEs face. The Figure below shows the *External financial instruments vis-à-vis the availability of information and the asset structure of an SME.*



In the figure, the horizontal axis represent the financial growth cycle of small businesses and the vertical axis divides SMEs according to their asset structure. It is characteristics to the figure that firms' options of different financial instruments widen towards the top right-hand corner of the matrix where the extent of information symmetry and the tangibility of assets are the greatest. This is to say that the more established, the larger and the more tangible a business is; the broader is the extent of financial instruments the firm is likely to access. The matrix also divides debt and equity finance on the basis of the contract theory arguing that the more knowledge-intensive and, hence, the more intangible the assets of a firm are; the more suitable equity finance becomes. This is because equity finance provides a firm with flexibility, and brings the incentives of a manager and financier closer to each other. As a simplification, the asset structure may also allow SMEs to be divided in an industrial basis: For example, a small high-tech firm may have mainly intangible assets such as specialised skills and knowledge of a start-up team. In contrast, another start-up firm in a more traditional industry may count more on its success in local markets, which is still intangible but possibly more quantitative and hence a more controllable asset that creates value.

BEST PRACTICE IN FINANCING SMEs IN CENTRAL AND EASTERN EUROPEAN COUNTRRIES

In May 1998, within the framework of the Southeast European Cooperative Initiative (SECI) the United Nations Economic Commission for Europe (UNECE) organized an *Expert Meeting on Best Practice in Financing SMEs*, covering the various countries in transition in Central and Eastern Europe, together with Greece and Turkey. The advanced transition economies from the Central European Initiative (CEI) also joined to this project. There were in total 12 submissions from Albania, Bulgaria, Croatia, Czech Republic, Hungary, The former Yugoslav Republic of Macedonia, Poland, Romania, Slovakia, Slovenia, Greece and Turkey.

In November 1998, the Permanent Secretary of the Black Sea Economic Cooperation (BSEC), the Konrad Adenauer Foundation and UN/ECE convened a *Workshop on SMEs - Their Needs for Human and Financial Resources* in Chisinau. A *Workshop on Micro Credits and Credit Guarantee Funds* to be held in May 2000 in Sofia reviews the latest achievement in financing start-ups and small enterprises in the BSEC region. Recommendations on these Meetings are available at the UNECE web-site. [1]

The largest programme in assisting setting up financial schemes in Central and Eastern Europe is the PHARE established by the European Commission. According to an interim evaluation it states that " a single programme often included a variety of SME credit schemes: micro loans, small loans, guaranteed funds, lines to buy imports, lines to buy equity in SMEs, etc. Substantial amounts of resources were made available to SMEs at a time when they had no real access to bank credit. No information exists in the evaluation reports on the record of debt servicing. Funds in early equity schemes were not utilised and the available amounts were reallocated to other credit lines (Poland). In many countries, the impact of financing schemes was blunted by the reluctance of the banks to participate, a factor that could have been identified if more preparatory and design work had been undertaken earlier." [2] This evaluation is valid even today. The changing government officials even in the most advance associated countries are not interested in getting clear picture and they do not prepare impact assessment on the efficiency of the newly create financial intermediaries in their countries.

At time being majority of the CEE countries (CEECs) have introduced ***credit guarantee schemes*** (except of Albania, Bosnia and Herzegovina, The former Yugoslav Republic of Macedonia and Moldova, and majority of the CIS). It is too early to judge the performance of these schemes, especially concerning their sustainability and impact on the development of the SME sector. These schemes could only be justified if they provide "additionality": they provide access to loans to SMEs who would not otherwise obtain this finance. Guarantee schemes should aim at sustainability, covering their costs from fees and other income. Participating banks should share in the risks, with the guarantee covering no more than 60 to 80 percent of the loan. They are not panaceas for providing finance to SMEs. In most CEECs, where the financial and judicial systems are weak and basic analytical capability is lacking, they are unlikely to be the key to unlocking financial services

[1] See "Index of SME Development" at http://www.unece.org/indust/sme/ece-sme.htm.

[2] The Phare Programme: An Interim Evaluation, European Commission, June 1970.

for SMEs.

Direct financial assistance centrally provided to SMEs through credit subsidies, tax reliefs, favourable depreciation allowances, employment or training grants can also be done through the tax system though this presupposes a very sophisticated and reliable communication system, and a high level of moral compliance with information requests.

It is important that where assistance is given to SMEs, it is accompanied by very specific conditions and should, wherever possible, be limited in time with the intention to phase them out as the circumstances and economic conditions changes. Experience seems to show that even when time passes and it is not by any means clear that some of these assistance measures are still necessary, it becomes difficult to dispense with them and they can begin to have a "corrupting" influence, weakening business efficiency and competitiveness.

1. MICRO-CREDIT SCHEMES

Economic performance and growth varied considerably among the 27 CITs of the ECE region. At the end of December 1999, the total number of registered unemployed in the CITs exceeded 19 million, the largest number since records began in early 1990s. [3] This is an increasingly painful problem as traditional safety nets have been weakened under the pressure to reduce public expenditure. Eligibility rules for unemployment benefit have also been tightened. Due to the collapse of the former centrally planned economies, increasing inflation and economic uncertainty personal savings have been eroded and people lack the financial reserves to start a business. However, in underdeveloped regions, rural and industrial districts facing structural adjustment needs, micro-enterprises might provide the way out of stagnation. SMEs could play a significant role in these underdeveloped regions because they produce and distribute local products and provide services and in doing this they could generate jobs and create income for the population whether they full or part-time.

The new emphasis on micro finances was started in the 1990s through programmes and activities such as - the Consultative Group to Assist the Poorest (CGAP), set up by the World Bank and several donors in 1995 which resulted in significant help being promised by donors in the form of micro credits to organisations engaged in distributing such financial services. CGAP is a micro finance programme, which is a multi-donor effort to reduce poverty by increasing access to financial services for very poor households through financially sustainable institutions. [4] The Microcredit Summit held in 1997 in Washington D.C., was the first step of a decade-long campaign which seeks to ensure that 100 million of the worlds poorest families will be receiving credit for self-employment by 2005. The number of poor is also increasing in the 27 CITs of ECE region, where the registered 19 million unemployed in 1999 are living below the poverty level.

Much has been written about micro credits in the CIT, in part due to the worldwide donor support for such forms of financial assistance and the use of micro finance, in many countries, to assist the smallest and poorest units. A UNECE paper prepared for the Microcredit Summit highlighted, that in CITs of the CEE, as a consequence of industrial and agricultural restructuring during the transition to a market economy, self-employment has

[3] Economic Survey of Europe, 2000 No. 1.

[4] See at http://www.cgap.org.

increasingly become an employment option for the many unemployed, including millions of people living below the poverty line. Many unemployed individuals are forced to turn to self-employment as a means to create income for themselves and their families. To facilitate the transition to a market economy in CITs and help victims of the economic transformation process overcome poverty and start life afresh, there is a need to launch micro credit programmes in all CITs. [5]

Micro finance in CEECs in usually does not belong among the primary tools of Government support in promoting SMEs yet. Micro-crediting schemes are provided rather through NG0s or specially created micro finance institutions. Loan applications and processing are simplified and demand for collateral is minimised or eliminated. Commercial banks do not like micro credits because of the high transaction costs and lack of expertise. The President of the Hungarian Credit Bank stated at the 3rd session of the Advisory Group on Entrepreneurship and SMEs of the OECD held in October 1996 in Visegrád (Hungary) that credit banks do not understand how SMEs operate. He mentioned that his bank lost significant amount of money within a few years as it started lending to SMEs.

Micro finance are provided through NGOs or specially created micro finance institutions. Loan applications and processing are simplified and demand for collateral is minimised or eliminated. Loan amounts schemes in developing countries are generally very low - around US$ 300 to 500 - for first credits, for repayment periods of 6 - 12 months, rising in some programmes to loans of US$ 2,000 - 3,000 for repeat borrowers who have successfully repaid smaller loans and whose businesses are considered to be stable and growing. In CEECs micro credit schemes could reach the desirable impact if they should provide loans for microentrepreneurs to become self-employed in the order of magnitude of between USD 5000 to 10,500 – in the advanced EU countries EUR 25,000, which should consist of a real financial allocation plus a soft component oriented to training and counselling.

Not surprisingly donors have developed a number of projects to help CITs design and implement micro credit programmes. Although in reality the overwhelming majority of the smaller businesses in the CIT are in fact, by all definitions, microenterprises, this category has been defined at rather a higher upper limit than in most of the developing countries. Thus several credit programmes, though described as small enterprise loan programmes, in practice, include micro credits as a greater part of their operations, with the recipients mainly micro businesses, according to the European definition, i.e. having less than 10 employees.

In March 2003, the European Council urged Member States to pay special attention to microcredit in order to encourage small enterprises to get started and grow. In addition, the importance of this issue was confirmed by national experts and finance practitioners in a high-level final report completed in November 2003 by the Enterprise Directorate General for the Enterprise Policy Group: "Microcredit for small businesses and businesses creation: bridging a market gap". As a follow-up, the Microcredit European Conference (MEC) was organised by the Enterprise Directorate General in partnership with the European Microfinance Network (EMN), the Microfinance Center for CEEC & CIS (MFC) and the Network of European Financial Institutions (NEFI) in Brussels on 21-23 September 2004.

"Microcredit has proved to be an efficient and effective tool for promoting entrepreneurship and is therefore a key catalyst for individuals who are willing to create and

[5] Antal Szabó: Microcrediting SMEs in CITs, UN/ECE, Geneva, January 1997.

develop their own business", said Enterprise Commissioner Olli Rehn. "We should now focus on how to make microcredit more accessible for companies all across Europe so that this can be used as a real instrument for growth", added Commissioner Ján Figel'.

The Conference confirmed the potential of microcredit in fostering entrepreneurship. These micro-loans are particularly useful to promote self employment and the creation of small businesses in the services sector, where access to credit is often difficult. Looking ahead, the Conference saw the dissemination of good practices, moderate and assessed financial support of public authorities and an appropriate legal and fiscal framework as being necessary to strengthen the dynamism of the sector.

Best Practice in Microcrediting in CITs

Albania

The EU PHARE programme started working in Albania in 1992 with a credit line of ECU 1.1m together with some technical assistance aimed at private microbusinesses. A British consulting firm with considerable experience of the creation of regional SMEs, Lancashire Enterprises plc managed this project until 1994. In the subsequent years a number of donors were active, including PHARE that helped to set up the Albanian SME Foundation and a network of 7 regional development agencies. The German aid programme, GTZ, financed an SME promotion, UNDP had devoted its aid to Private Sector Development, USAID helped through an SMEDA (Small and Micro Enterprise Development) project. [6]

The major project during these years was launched in Albania by the World Bank through setting up the Rural Development Fund, which in 1995 became the Albanian Development Fund (ADF). It relied on local administrative committees to channel credit to final clients. As of 31 March 1994, 40 village credit funds had been established and 1,300 sub-loans had been disbursed. **The** average loan size was USD 287. The loan recovery rate is 100 per cent, which indicates the efficiency of the project. [7] By the time being 9200 active loans have been launched with 99.48 % repayment rate. Based on the initial excellent results as part of the Balkan Stability Pact the Central European Initiative and UN/ECE are cooperating in establishing a micro-financial scheme for crisis affected areas in Albania According to the situation and the kind of production/services in the villages selected, the loan could vary from US$ 500 to US$ 1,000 per loan.

Armenia

Since 1997, many humanitarian organizations such as USAID (USA), GTZ (Germany), the International Foundation of Agricultural Development (Italy), ECLOF (Switzerland), ICCO (Netherlands), and Izmirlyan Foundation (Switzerland), have provided microfinance services to the most vulnerable layers of the Armenian population in order to support small business - the biggest slice of registered business in Armenia. These services

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[6] Mr. Quemal Balliu: Case Study on Albania,SME Foundation (Tirana), Expert Meeting on Best Practice in Financing SMEs, Geneva, 1998.

[7] Leila M. Webster, Randall Riopelle, Anne-Marie Chidzero: World Bank lending for small enterprises 1989-1993. World Bank technical paper No. 311, 1996.

include granting small and medium credits, mainly non-collateralized, to entrepreneurs who cannot afford the services of commercial banks. The total number of the programs' beneficiaries is about 30,000.

Most microfinance institutions are registered as non-profit foundations whose loan-granting activities do not fall under the government's licensing requirements. Simultaneously, since the second half of 2002 the "Law on Credit Organizations" was adopted to regulate the loan-granting activities of commercial organizations, which according to law should be licensed by the Central Bank of Armenia (CBA).

In order to provide Microfinance Institutions (MFIs) a wide range of consultancy services, training courses and to support them in joining forces for problem solving and networking, since October 2002 the Financial Banking College Foundation (FBCF) began implementation of the "Bank and Non-Bank Financial Institutions Mentoring and Training" (BNBFIMT) program, supported by the Shorebank Advisory Services grant, funded by USAID. One of the six main directions of this program is the "Assistance to MFIs", which has the following objective: to contribute to MFIs in order to create a competitive and stable micro-business market in Armenia.

Hungary

Hungary, one of the advanced associated CIT that has attempted to develop a distinct micro credit programme. The maximum micro credit is HUF 1 million (approx US$ 5,000). The loan can be used to purchase machinery, equipment and other fixed assets. No more than 30% of the loan can be used to finance current assets. Loan applications were submitted through the Local Enterprise Agencies. By mid 1997 almost 8,000 such micro loans had been disbursed for a total of HUF 4.7 billion (US$2.25m - average loan size US$ 2,810). These amounts indicate a larger size of micro credit than is usual in most micro finance programmes in other countries but this is partly explained by the higher limit of the definition of such businesses in Hungary.[8]

Poland

In Poland a unique micro finance schemes called Fundusz Mikro was established in 1994 by the Polish-American Enterprise Fund. Fundusz Mikro began its lending operations in February 1995 with a one-year pilot program in which it systematically tested different lending methodologies, locations, types of clients, types of employees and co-operation arrangements with partner organisations. Based on the results of the pilots, it has, since February 1996, built a nationwide network of 11 branches and 1 main office (Headquarters). As of February 1998, it had a loan portfolio of over $8 million and served over 8,000 clients. In September 1999, Fundusz Mikro reached operational break-even. [9] As of December 1999, it had disbursed over US$ 50 million and serves 18,060 clients. The default rate as of outstanding balance is 3.78 %. [10] The Star-up loans is limited to US$ 1,200 and for a period

[8] György Borbély and Mihály Molnár: Case Study on Hungary, Hungarian Foundation for Enterprise Promotion (Budapest) Expert Meeting on Best Practice in Financing SMEs, Geneva, 1998.

[9] See at http://www.bellanet.org/partners/mfn/poland.html.

[10] Publication of the Micro Finance Centre, Warsaw, Winter/Sping 2000.

of six months. This loan is secured by personal guarantee of three co-signers, who form a group of borrowers. In addition, the beginner entrepreneur has to present a businee plan for the period of the planned loan to demonstrate how the installments will be financed.

Fundusz Mikro has been developed an innovative, computerized loan portfolio risk assessment system, or tool, which is used to control default risk at a time when Fundusz Mikro is undergoing rapid expansion of its lending operations. The loan portfolio risk assessment tool that Fundusz Mikro is an innovation in the micro finance field because it is more sensitive and sophisticated that traditional credit-scoring processes.

Romania

In Romania the Micro Loan Program of the Romanian-American Enterprise Fund operates in co-operation with the CAPA Foundation in Cluj-Napoca, Craiova and Iasi, and in co-operation with the Cooperative Housing Foundation (CHF) in Timisoara, Deva, Arad and Resita. Through this program, the Fund encourages and supports emerging small private business in Romania by providing loans to local entrepreneurs as follows:

- dollar denominated loans from US$ 2,500 to US$ 15,000;
- up to 18 months term;
- fixed interest rate;
- flexible collateral requirements; and
- loan proceedings: fixed assets (e.g. equipment, tools), working capital.

An other promising scheme is Cooperative Housing Foundation (CHF) has been active in Western Romania since 1994, implementing a field-based, multi-faceted development project that integrates civil society development, alternative credit mechanisms, small and medium size enterprises (SME) development, and quality-of-life improvements for low and moderate income families. In the first five years of its existence, CHF/Romania successfully provided more than US$3.5 million in development assistance to area organizations and strengthening local economic development, both through direct infusions of loan capital and through technical assistance activities to the local population.

Slovakia

In Slovakia, the National Agency for Development of SMEs (NADSME) has been operating a loan programme for SMEs using the contributions from the Slovak government, the PHARE programme of the EU (contributions to NADSME) and funds from some Slovak commercial banks. Eligible for loans from this programme are enterprises who started their activities after 1990, have less than 500 employees, and at least 50% of the firm's equity is in private hands. The firms must be registered and have their main office in Slovakia and be engaged in manufacturing, crafts or services (farming and trade firms are excluded). The loans should be used for purchase of machinery, equipment or inventory (raw material, stock purchase should not be more than 50% of the loan). This loan programme is in the form of a revolving fund so that loan repayments are used to finance other SME projects. As of end of 1996 the fund available from the programme was SKK 1,311 m (US$ 37m).

Apart from the support loan programme as it is called, there is also small loan and micro credit schemes. The former scheme, which gave its first loan in April 1994, had disbursed the whole fund of ECU 1 m by August that year - a total of 120 loans to a maximum of SKK 200,000 per borrower. The micro loan scheme was launched in the first quarter of 1997 as a pilot project in three selected Regional Advisory and Information Centres. Micro loans are available for amounts between SKK 50,000 and SKK 300,000 (US$1,400 to US$ 8,500). In general these loans are for a maximum period of 3 years (with a grace period of 3 months) and must be covered by the assets purchased with the loan. By mid 1997, 1,900 micro loans had been granted for a total of SKK 5 m (US$ 143,000). [11]

Russian Federation

VOZMOZNOST is an other umbrella organization for not-profit financial companies and non-profit training and service organizations established by Opportunity International. It was responsible for creation of the Nizhnii Novgorod organizations SLUZENIE (Service), now an independent NGO resource center in the Russian Federation. In 1995, Slushenie formally registered as an association of NGOs with 20 members. Its members included NGOs with a focus on art, charitable organizations, children, and the disabled.

Summary of Microcredit Operation

Microcredit has proven to be an efficient and effective tool for economic development and promoting entrepreneurship, a key instrument for individuals intending to create and start-up their own businesses. Microcredit could be use as a valuable instrument to facilitate creation of entrepreneurship, the economic growth and all CITs and the European economic space including the BSEC countries. To overcome the difficulties faced in credit provision to small enterprises the following steps should be considered:

1. Improve the legal and regulatory framework for microcredit.
2. Offer very small loans to crafts, services or other microenterprises to test and train these borrowers and to show them that if they repay they will be helped to borrow more and to expand.
3. Help disadvantaged groups - ethnic minorities, displaced persons, women, rural communities, youth, unemployed, etc. - to become self-employed and to consider starting independent business activities.
4. Provide technical assistance and training programmes to the various staleholders involved in microcrediting.
5. Encourage those who are reluctant or afraid of going into debt to take out some very small loans to take the first steps in setting up their own business. Governments, NGOs and international donor institutions are encouraged to launch micro-credit schemes in order to create self-employment for the unemployed and to fight against poverty.
6. Promote microcredit in the BSEC region by disseminating best practices.
7. To monitor on a regulat basis the progress of microcredit activities by the BSEC Working Group on SMEs.

[11] Juraj Majtán: Case Study on Slovakia, National Agency for Development of SMEs (Bratislava), Expert Meeting on Best Practice in Financing SMEs, Geneva, 1998.

2. CREDIT GUARANTEE SCHEMES

Access to bank loans is particularly difficult for these SMEs because of insufficient collateral. Certain developments in the European financial sector may also increase the difficulty for SMEs to obtain sufficient amounts of bank lending at reasonable interest rates, such as the forthcoming capital adequacy accord (Basel II). The problem of insufficient collateral can be overcome by guarantees given by public or private guarantee or mutual guarantee institutions.

> The Basel Committee has published a revised framework agreement that aims to make the international financial system safer by having the riskiness of banks' loan portfolios to be reflected in the capital charges they need to set aside against unexpected losses. The agreement (called "Basel II") sets out the details for adopting more risk-sensitive minimum capital requirements for banking organisations. The Basel II framework is an important issue for SMEs and small banks to the extent that it affects bank behaviour and their willingness to lend to SMEs.

The lack of adequate collateral is commonly stated as one of the significant constrains to SMEs obtaining access to credit from commercial financial institutions. Banks generally afraid of loss in case of under-collateralization of SMEs and this is why they do not like to lend credit to SMEs. The objectives of *credit guarantee schemes* (CGS) is to share the risks of the lending through reimbursing the lenders part of the losses incurred from loan defaults by SME borrowers, are now seen as filling a gap in helping SMEs, especially those with growth potentials, obtaining access to formal bank credit. In the last few years there has been a resurgence of interest in such schemes. The observations and recommendations of the Round Table Meeting on Credit Guarantee System held in 1996 by the Inter-American Bank are valid and highlight the issues of CGSc. [12]

There is now less donor credit available for formal SMEs who still urgently need access to finance. Credit guarantee schemes can now be seen as a possible way to expand the availability of finance to this group and may be an option for closing the gap that now has developed between funds available for the very small microenterprises and to larger growing SMEs.

Most of the transition countries of CEECs have introduced guarantee schemes. CGS generally started in Europe although a scheme was developed in Japan in as early as 1937. Germany started a guarantee system in 1954, Italy in 1960 and Netherlands, Belgium and France in the 1960s. There are also schemes now operating in Finland, Norway, Denmark, Greece, Ireland and Turkey and other European countries.

The European Commission’s SME Guarantee Facility is part of the European Commission's Growth & Employment Initiative and is aimed to increase the availability of loans to small or newly established firms through risk sharing with national guarantee schemes, mutual guarantee schemes and other appropriate institutions The size of the guarantees will be set contractually and could amount to 5-10% of the original face value of the underlying loans. An indicative figure of ECU 150-190 million was envisaged for this

[12] See Doran & J Levitsky (1997) Credit Guarantees - A Global Perspective - for DFID, UK, Bannock Consulting, London and "The Financier", Issue on Credit Guarantee Schemes, (Feb/May 1997), Inter American Development Bank, Washington DC, US.

scheme over the period 1998-2000 (ECU 50 million in 1998). The SME Guarantee Facility, by targeting businesses involving a comparatively high element of risk, complements the operations of the EIB and the EIF. [13]

In the CIT, credit guarantee schemes appeared in the early days as a very attractive and effective instrument for financing SME and this view was fostered by various donors including PHARE Programme, the Austrian and German technical assistance programme (GTZ) as well as, to a lesser extent the Canadian US and UK bilateral aid organisations. Lack of collateral appeared as a major problem as the new private enterprises in the CIT approached relatively new and inexperienced banking and financial institutions for loans either to start or expand their businesses.

The experience of the CIT, as in other countries, has shown that the design and implementation of CGS takes longer than originally envisaged and a part of this is due to inexperience of the banks and a fear by the lending institutions that loan recovery and repayment of guarantees in the event of default would prove difficult.

Practice in Croatia [14]

The Croatian Guarantee Agency (CGA) has been set up as an independent non-profit financial institution pursuant to the distinctive legal Act (Act on the Croatian Guarantee Agency - Official Gazette No.29/1994 of April 11,1994). Operationally it started to work in second half of 1995. The CGA was set up with the technical and financial assistance of the Austrian Bürgesförderungsbank. The Agency is a non-profit institution, and the realised profits shall be used for attaining the Agency's objectives. Therefore the Agency has no obligation to pay taxes on profit, but has an obligation to pay all other taxes.

The founding capital of the Agency is obtained from the budget of the Republic of Croatia and amounts to DEM 5 million in domestic currency. The financial resources for the Agency's transactions and work shall be covered by the budget of the Republic of Croatia and by the Agency's activities. Guarantee potential for the year 1997 amount to kunas (Kn) 150 million (as of February 2000, 1 EUR = 9.8 kn) with possibility to grow.

The CGA may obtain the guarantee and/or support exclusively for the projects financed through a loan and involving the material investments (equipment, facilities, business and manufacturing premises, long-standing plantations and basic herd), connected with the carrying out of the activities of the entrepreneurs, where creditor's criteria have not been met only with regard to the instruments securing the servicing of the loan. The Agency is also providing a subsidy for reduction of the cost of the loans which have been granted to small entrepreneurs by banks and savings banks.

The "Start Programme" provides a maximum 80 % guarantee up to kn 400,000. Special consultation services could be provided against fee. Withing the framework of a "Development Programme" maximum kn 11 million could be provided at the level of guarantee up tp 75 %.

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[13] See at http://www.cordis.lu/finance/src/sme.htm.

[14] Vladimir Zanic, Ms. Dragica Karaic (Ministry of Economy) and Mr. (Croatian Guarantee Agency, Zagreb), Case Study on Croatia, Expert Meeting on Best Practice in Financing SMEs, Geneva, 1998.

Practice in the Czech Republic [15]

In the Czech Republic the guarantee system was set up through a bank, the *Ceskomoravská zárudní a rozvojová banka* (Czech and Moravian Guarantee and Development Bank - CMGDB) with 49% state holding and the remainder in the hands of the major banks in the country. The idea of setting up a separate bank followed the Austrian Bürgesforderungsbank, which helped in the establishment of the guarantee system in the Czech Republic and Slovakia. CMGDB was one part of a network of supporting institutions for SME, which included various funds as well as regional consulting centres and business innovation centres (BIC). These institutions received considerable support through the PHARE programme of the European Union.

Originally the state's share in the CMGDB was 33% but this was raised to 49% in 1994. The equity of the CMGDB was close to 1.5 m CZK in 1996. Between 1992 and 1995 the CMGDB received CZK4,800m (US$ 175 m) from state funds for the financing of its credit programmes. Its operations were built up through working together with various established banks in the country and at the end of 1995 there were agreements with 37 such financial institutions that together had over 700 branches in the Czech Republic. However it is reported that real operational relationships only developed in 1993 with 15 banks, despite efforts by the CMGDB to hold informative seminars to promote and explain the credit and guarantee programmes. CMGDB is also developing a group of about 50 consulting firms to help banks and enterprises in using the schemes. In 1996, the CMGDB also started to improve contacts with the network of chambers of commerce to inform them and to try to collaborate on the schemes.

The business activities of the CMGDB included the approving of guarantees and of state interest rate subsidies to SMES. In 1993 the CMGDB approved 547 guarantees but by 1995 serious loan recovery problems had begun to develop. In April 1995 the bank revised the design of the programme (tightened the approval of guarantees) basing it more on the experiences of the Austrian and German guarantee banks. As a result the number of guarantees approved dropped significantly to 176 for a total of CZK 917.5 m (US$27m) in 1995, which secured loans of CZK2026 m (US$ 60 m), making the average guarantee portion 45.3% of the loan. In 1998, the CMGDB approved 276 guarantees for a total of CZK 1,571m, which secured loans of CZK 2991 - at 52.5% guaranteed portion level on average.

In the Czech Republic, as distinct from other CIT, the guarantees were mainly for industrial projects which accounted for 73% of guaranteed loans in 1992 (the first year of operation of CMGDB) but fell to 41.3% in 1995, however it recovered in 1998 again for 73.9 %.

Summing up the Czech experience over the 1992-1998 period, it is the view of the CMGDB that the bank guarantees could become an effective instrument for supporting SMEs but they do see it as important that 10% - 30% in the financing of projects should come from the investor(s). Czech experience seems to show that entrepreneurs should be influenced not to be over ambitious and to develop their business plans more gradually, in stages.

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[15] See Lubomir Rajdl:Case Study on the Czech Republic, CMGBD (Praha), Expert Meeting on Best Practice in Financing SMEs, Geneva, 1997, and Financial assistance to SMEs in the Czech Republic, Forum on Best Practice in Development Entrepreneurship and SMEs: The Czech Experience, 2 June 1999, Geneva-

In the Czech Republic, experience has shown that all forms of credit support (including guarantees) for SMEs involve high risks. It is believed that financial credit guarantees for entrepreneurs and their projects on an increased scale is not possible without significant state support. This state support may come through an increased guarantee fund or through payment of operational costs or in other forms such as a government "re-guarantee". At the moment the Czech Republic maximum guarantee is around 70% but experience of the Czech Republic seems to show that a higher guarantee proportion of 80 - 85% would be desirable to have a ma or impact on the present conditions, certainly for start-ups. Without increased state support all guarantee systems, in the view of the CMGDB, will have to follow a cautious approach which will mean the number of guarantees will be relatively low with a correspondingly smaller impact on SME development.

Practice in Hungary [16]

In Hungary there are three credit guarantee institutions issuing guarantees for credits guaranteed to small businesses, the Credit Guarantee Company (CGC), the Rural Credit Guarantee Foundation (RCGF) and the Start Credit Guarantee Fund. If the credit has a rural or agricultural client, the bank will use the RCGF. If it is for a start-up, it will use the Start CGF which is operated by the Hungarian Foundation for Enterprise Promotion (HFEP). In all other cases the bank will use the CGC, which is, in fact, the largest of the Hungarian credit guarantee schemes.

The CGC was founded in December 1992. In 1994 its base capital amounted to HUF 4.81 billion (US$24m). CGC is owned by the following organisations: the Government of Hungary, the State Privatisation and Property Co., 28 commercial and specialised banks, the Hungarian Foundation for Enterprise Promotion, 40 savings associations and by 10 representative organisations. The maximum guarantee which the CGC will offer is up to HUF400 m per borrower (US$2m) following very liberal eligibility rules requiring only that the SMEs should be run by Hungarian nationals and employ less than 300 people.

In 1998, CGC's guarantees amounted to HUF 27 billion, contributing thereby to the allocation of HUF 49 billion credit, and its guarantee obligations totalled HUF 42.5 billion. In 1998, the average guarantee amount was HUF 19 million. Under the agricultural capital injection credit scheme and credits extended by savings co-operatives, this was the most typical form of small-scale borrowing. CGC can guarantee maximum 90 % of the credit up to HUF 10 million. Over this amount the limit of the guarantee is maximum 80 %. The average extend of guarantee is around 60 %. [17]

The fee for the guarantee service includes a handling "fee"; (an average of 1%, to be paid in advance) and an annual guarantee fee component (generally 2% up to 4% in the case of foreign currency working capital credits).

In 1998, in addition to the CGC, the RCGF provided guarantee to a total amount of HUF 23.9 billion credit and approved 1,948 credit guarantee applications. In 1998, by client number, sole proprietors ranked topmost - 609 applications - followed by limited liability

[16] György Borbély and Mihály Molnár: Case Study on Hungary, Hungarian Foundation for Enterprise Promotion (Budapest), Expert Meeting on Best Practice in Financing SMEs, Geneva, 1998.

[17] State of the SME Business in Hungary: Annual Report 1999, Institute for Small Business Development, Budapest.

companies - 563 applications - , while agricultural co-operatives and original manufacturers occupied third and fourth place - 262 and 260 applications, respectively.

Some government agencies and commercial banks in Hungary have held the view that the CGC is not using all its guarantee capacity and is over-cautious in issuing guarantees. Fees of the CGC and the HFGP are also considered too high. There are complaints that the CGC changes its conditions too often. Apparently, there have been eight such occasions since 1993. While the banks believe that CGC's demand for documentation is reasonable, the RCGF request for credit documentation is simpler than that of the CGC. Also it takes only five days to obtain a guarantee approval from the RCGF while the CGC takes 30 days for the approval of long-term credit and 15 days for a short-term credit guarantee. By international standards however, these delays are reasonable.

The proportion of credit leading to guarantee claims is highest for the Start Credit Guarantee Scheme and lowest for the CGC. There is some feeling in Hungary that the Start Credit Guarantee Fund has been an over-costly programme.

Practice in Poland [18]

Within the framework of the Government SME policy the Ministry of Industry and Trade intent to set up a Credit Guarantee Fund (CGF) for SMEs already in 1992. However, only the 1994 State Budget allocated sufficient amount of money to establish a CGF and operate in the National Economy Bank, in one of the two wholly state-.owned bank in Poland. In 1997, CGF was transformed into a National Credit Guarantee Fund and several modifications were introduced in its operating. The Funds operated four schemes of extending guarantees:

(i) Simplified methods: guarantees are provided for small credits less than ECU 100,000 with the ceiling of guarantee up to 50 %. Guarantee are extended within 3-4 days;
(ii) Full course of guarantee: these guarantee are extended for medium-sized companies for credits between ECU 100,000 and ECU 1.5 million with maximum 70 % of the total amount of credit excluding interest. The National Economy Bank performs a full financial risks analysis on each application. Such guarantee can be extended within 2 weeks;
(iii) Extending guarantee through a guaranteed promissory note: this scheme is used for clients not cooperating with the National Economy Bank. The procedure is same as in case (ii); and
(iv) Issuance of portfolio guarantee targeted at SMEs.

According to the experiences the Fund's financial losses are less than 1 % of the total amount of extended guarantees. The target is to extend guarantee in the amount equal to near Z≈oty 80 million (equivalent to near US$ 30 million).

Practice in Romania

Romanian Loan Guarantee Fund for Private Entrepreneurs (RLGF) is a new financial

[18] Kristof Slifirczyk: National Credit Guarantee Fund in the National Economy Bank, Expert Meeting on Best Practice in Financing SMEs, Geneva, 1998.

instrument that was introduced in 1994. It was established as a reaction to the large gap between the demand for financial support the private sector has showed on the market and the low supply of bank credits. Under circumstances of a general framework that has been unpropitious for entrepreneurial development and given that the economic environment has displayed unpredictable movements of the macroeconomic indicators, the Romanian banks were reluctant to crediting the private firms because the banks themselves going through a learning process concerning the rules of the market economy.

RLGF was established to be a reliable partner for partially taking over the credit risk. Its presence allowed for capital inflows and for the increase in the credits the small and medium sized companies received. RLGF is a new and modern institution established with very valuable assistance from the Canadian Bank for Development. Thus, the RLGF managed to impose on the Romanian market the cash-flow analysis model for assessing the project viability and for evaluating the business credit eligibility.

At the same time, the Fund was able to compete openly with other financial companies and registered profits every year without resorting to state subsidies or exemptions. Thus, RLGF gained its social role as promoter of the Romanian middle class development and as supporter of government policies targeting private sector growth and consolidation.

The Fund participation in the restructuring process of the Romanian economy resulted in letting the entrepreneurs gain access to credits in total value exceeding 400 billion lei following guarantees of 150 billion lei released by RLGF up until now. The small and medium size companies could not have access to these amounts without support from the Fund. The availability of these amounts allowed the private companies to make investments of more than 450 billion lei. Thus, they could buy new equipment and could introduce new technologies for their production lines. The Fund supported important economic objectives in sectors like furniture, construction raw materials, paper industry, textiles, food, etc. [19]

An other special financial intermediary, the Romanian-American Enterprise Fund (RAEF) is a private U.S. corporation whose mission is to promote free enterprise and entrepreneurship in Romania through investments in and loans to small and medium size enterprises. Established by the President and the U.S. Congress in 1994, RAEF was capitalized by a $60 million grant from the United States Agency for International Development. [20] At the end of 1999, RAEF announced a new initiative worth $2 million dollars aimed at providing financial assistance to SMEs in the three counties of western Romania. The funds will be used for both loans and equity investments.

"Through this new initiative, RAEF will make loans up to $150,000, primarily to businesses that have been affected by the Kosovo crisis," RAEF President Klipper said. "For equity investments, preference will be also given to affected companies. The program is expected to last for one year, and will operate on a ‘first come, first served’ basis."

SMEs from the manufacturing, service, or trade sectors with less than 200 employees may apply under this program. The businesses must be majority-owned by Romanians and must be majority privately owned. Eligible businesses may apply for loans up to $150,000 or equity investments up to $350,000 or a combination of both.

[19] See at http://www.investromania.ro/frgc.html.

[20] See at http://www.raef.ro/English.htm.

Practice In Slovakia [21]

A loan guarantee programme is operated in Slovakia by the National Agency for Development of SMEs (NADSME) through the Slovak Guarantee and Development Bank (SGDB), following the pattern of the CMGDB in the Czech Republic. The guarantee scheme for SME of the SGDB was founded in 1992 with a contribution of ECU 2m from PHARE programme funds and co-ordinated by NADSME. An equal amount was contributed by the Slovak government.

In 1993, the guarantee programme for SME from PHARE funds was reorganised. Subsequently in November 1994 both the above mentioned programmes were merged into one guarantee scheme for SME. Under this programme, as of the end of 1996, 108 credit guarantees had been given for a total financial volume of SKK 210.933 million (US$ 6m).

Practice in Slovenia [22]

Credit guarantees in Slovenia are provided through a scheme operated by the Small Business Development Fund (SBDF) nationally and also a range of regional guarantee funds (RGF) are operated through the Regional Business Centres. The RGF in practice are the main instruments for providing guarantees for SME lending, receiving their funding both from the SBDF and from local resources. These RGFs tend to operate similar to MGS in that those firms wishing to obtain guarantees have to pay a one-time admission fee as investment in the Fund, usually around about US$ 300. In this way, the entrepreneurs have an interest in the successful operation of the Fund.

The RGF in Slovenia provide a 50% guarantee of credit with the bank covering the risk, either from its own resources or through equivalent securities from the borrower. Credit amounts through the Regional Development Centres which can obtain a 50% guarantee from the RGF are for amounts of US$ 6,000 up to US$ 60,000. Repayment periods are from one to five years and the interest rates aim at a real level of 6%. A further 1.5% is paid as commission fees to the guarantee fund. The credits are subject to a guarantee period of 6 months and a further US$18 is paid out for the costs of the guarantee fund to deal with the application. The maximum period, from the date of application submitted to the guarantee fund to the conclusion of a credit agreement will be 2 months although efforts are made to shorten this period.

In general, based on the resources available to credit guarantee funds, each fund is able to issue approximately 200 guarantees per year. RGF operate generally with a fund of US$2 m.

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[21] Juraj Majtán: Case Study on Slovakia, National Agency for Development of SMEs (Bratislava), Expert Meeting on Best Practice in Financing SMEs, Geneva, 1997.

[22] Staša Baloh-Plahutnik and Primo〉 Pohleven (Ministry of Economic Affairs), Zoran Širca (SBDF), Mr. Anton Bala〉ek and. Tomo Garantini (Developing Agency), Mihael Feher (Development Fund,Ljubljana): Country Study on Slovenia, Expert Meeting on Best Practice in Financing SMEs, Geneva, 1997.

SUGGESTIONS FOR DEVELOPMENT AND ESTABLISHMENT OF FINANCIAL SCHEMES FOR SMEs IN CEECs

In CEECs, as a consequence of industrial and agricultural restructuring during the transition to a market economy, self-employment has increasingly become an employment option for the many unemployed, including millions of people living below the poverty line. These new unemployed have become a new class of poor and economically marginalized people without previous experience or even knowledge of how to enter the market economy. Many unemployed individuals are forced to turn to self-employment as a means to create income for themselves and their families. However, there are difficulties and risks in entering the business world in a weak and hostile environment characterized by economic instability, high and growing inflation, transition bureaucracy, lack of information and credit facilities, and the presence of the grey economy and mafia. To facilitate the transition to a market economy in CITs and help victims of the economic transformation process overcome poverty and start life afresh, there is a need to launch micro credit programmes and credit guarantee schemes in all CITs.

The appropriate infrastructure for financial schemes - micro credit and credit guarantee institutions - has not been developed *in response to this requirement. Micro credit and credit guarantee organizations in CEECs* need a *combination of capacity-building, funding,* policy development and *performance-based* objectives to develop *into professionally managed, permanent and self-sustainable institutions. While establishing long-term capacity-building programmes, experimentation should* be encouraged to develop national *models, taking into* account thorough *strategic and business programming.*

Policy changes may be needed to allow an appropriate portion of the European Union's and the banking sources of funding into the CITs. The amount of aid for foreign counselling and advice should be decreased and financial funds should be provided for credit guarantee schemes for start-up entrepreneurs. Micro credit programmes should serve as a policy alternative to unemployment benefits and job training programmes, because they contribute to self-employment and economic self-reliance of poor and low-income families.

PRIORITIES FOR THE DEVELOPMENT OF FINANCIAL SCHEMES FOR SMEs IN TRANSITION ECONOMIES ARE:

1. Creation of an enabling legal and regulatory environment for SMEs and business operations;
2. Improvement of capacity-building, development of physical business support infrastructure - especially the establishment of micro-credit guarantee schemes -; for fostering the entrepreneurship,
3. Training for staff in lending and fund management, as well as for start-ups and beginners;
4. Providing soft advisory services for entrepreneurs, e.g. through business information centres established by multinational and bilateral aid programme or mentoring schemes; and
5. Collecting good practices and benchmarking in financial policies and practice, as well as on the impact of each governance mechanism on outreach and sustainability.