SAKCHYAM ACCESS TO FINANCE

DEVELOPING A ROBUST MSME CREDIT GUARANTEE FACILITY: UNLEASHING ACCESS TO MSME FINANCE IN NEPAL

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Contents

Acronyms

CGS	Credit Guarantees Schemes
MSME	Medium, Small and Micro Enterprises
A2F	Access to Finance
FI	Financial Institution
FSPs	Financial Service Providers
SACCOS	Savings and Credit Cooperatives
MFI	Microfinance Institution
DCGF	Deposit and Credit Guarantee Fund
NRB	Nepal Rastra Bank
DFID	Department For International Development
UNCDF	United Nations Capital Development Fund
GON	Government of Nepal
RBI	Reserve Bank of India
CGC	Credit Guarantee Corporation
CGTMSE	Credit Guarantee Fund Trust for Micro and Small Enterprises

Executive Summary

Nepal's micro, small and medium sized enterprises (MSMEs) are important engines of innovation, job creation, and growth but limited access to affordable and suitable financial services will continue to limit the sector's full potential. As is the case for most MSMEs around the world, access to working capital and investment credit is critical to run and expand businesses. But despite the obvious financial needs, banks show little interest in lending to new and potentially riskier market segments. To date, SMEs in Nepal represent only 2.7% of total commercial lending and IFC estimates the financing gap at USD 1.2 billion. With limited access, MSMEs resort to own funds or loans from MFIs, cooperatives and/or the informal sector, but such financial service providers (FSPs) are often hindered by capacity constraints, narrow product offerings, and limited scalability.

Given the dominant role of commercial banks in Nepal's economy, the potential range of affordable MSME product offerings and the capacity to scale such lending, access to formal credit in Nepal should be given a much higher priority. To date, supply side initiatives continue to focus on the symptoms of access to finance (A2F) - and not the underlying root causes behind financing gaps. Deprived sector lending and mandatory priority sector lending are well intentioned but sustainable A2F solutions call for a change in lending behaviours and development of market driven incentives that encourage banks to overcome entry barriers and invest in new product lines, procedures, and staff. Building off of the momentum set forth by NRB's recent monetary policy 2017/2018, stressing the importance of the productive sectors and expansion of formal credit by banks and financial institutions (BFIs) to priority sectors, it is urgent that appropriate A2F initiatives support sustainable expansion of commercial financing to the MSME sector. This is where credit guarantees schemes (CGS) can make a difference in spurring financial innovation and new types of lending to the sector. CGSs are increasingly considered as one of the most market friendly instruments that have the potential to unlock liquidity within the banking system and allocate much needed capital to MSMEs.

As seen in the numerous international cases covered in this paper, CGSs should be well-designed, well-funded and well-implemented in order to be effective. Currently, Nepal's Deposit Credit Guarantee Fund (DCGF) has statutory responsibility to perform both deposit and credit guarantees but its primary focus is the issuance of deposit guarantees. There are also numerous donor-led guarantee schemes (DFID, USAID) providing portfolio guarantees that facilitate lending to specific market segments. But, donor managed guarantee funds are limited by the tenure of the supporting programmes and the administration of increasing numbers of individual guarantee funds within donor-funded programmes will become a challenge. Given these challenges, there is a strong case for administering guarantee funds under one roof and establishing a robust guarantee entity capable of scaling CGSs in Nepal.

As stakeholders engage in dialogue on the future role of CGSs and consider optimal institutional delivery models, it will be critical to learn from international experiences and best practices. For this reason, the paper presents numerous CGSs throughout the world that provide key takeaways to help inform the design and implementation of new and expanded schemes in Nepal. A summary of best practices and key insights from international cases are highlighted below:

- **Establishment of a separate independent legal entities allows government to maintain a degree of control and ownership but permits funds to operate independently thereby improving operational and financial efficiency**. South Korea's KODIT and Malaysia's CGC were established as separate legal independent entities (CGC as a corporation and KODIT as a stand-alone public financial institution). Both CGSs benefit from strong institutional and operational mechanisms that contribute to the success of their respective schemes. On the other hand, the Central Bank in Sri Lanka carries out guarantee activities (as an agent of the government of Sri Lanka) and suffers from ongoing institutional and operational challenges. In fact, policy makers are currently exploring options to establish a separate guarantee entity (independent of the Central Bank) that delivers guarantees in an efficient and sustainable way and includes the participation of financial services providers

- Involvement of banks in the initial capitalization, ownership and funding of the CGS can be beneficial. Malaysia's CGC involved banks in the initial capitalization and ownership of the corporation and is continually forging strategic alliances with its partner banks. KODIT's CGS requires banks to contribute an annual % of total outstanding loans (much like donations to a foundation) into the fund. KODIT's unique revenue model bolsters buy-in from financial institutions and ensures a steady and diverse revenue base. In Kazakhstan, DAMU also aspires to becoming an independent legal entity with increased involvement of financial institutions in the capitalization of the institution. According to best practices, the involvement of banks early on in the capitalization of the fund greatly enhances the effectiveness and utilization of guarantees, ensures a stronger commercial orientation and provides additional sources of capital. Ultimately, contribution of banks in the capitalization of CGSs ensures they have a stake in the development and success of the scheme.
- Promotion of mixed public-private ownership and limitations on government involvement in the daily operations and management of schemes is considered best practice - Large scale public schemes such as India's CGTMSE (where public officials administer and manage the scheme) are too often vulnerable to the institutional and operational challenges inherent to solely public models. Although CGTMSE has made significant progress in bridging the MSE finance gap, there are legitimate concerns about its operational efficiency (risk assessment and claims settlement procedures), as well as the Trust's longer-term sustainability. Public schemes such as Sri Lanka's central bank-run CGS and Kazakhstan's DAMU also face institutional capacity constraints and operational challenges that have prompted efforts to restructure and increase private sector participation. Overall, best practices increasingly advocate limiting government involvement to the initial set up, ownership and control of schemes but limiting its involvement in the scheme's actual management and operations. This is particularly important in countries with weak institutional environments, where good governance remains a challenge and risk of political interference is high.
- Establishment of strong governance structures are fundamental to the success of CGSs - Sound corporate governance structures with independent board of directors are critical particularly for hybrid models where government holds majority ownership. Political intervention in CGS is still considered one of the major threats to the effectiveness of CGSs and needs to be considered when designing management and governance structures. Pakistan's DFID-funded CGS provides an excellent example of a well-designed scheme with a robust management and governance structure that clearly separates strategic oversight, daily management and fund management responsibilities.
- Careful selection and implementation of guarantee design features (coverage, delivery approach, pricing, claims procedures, eligibility requires) require constant navigation of the trade-offs between financial sustainability and development objectives. Pakistan's CGS includes key design features covering risk sharing arrangements, pricing and dynamic limit allocations that were fundamental to the schemes initial success. In contrast, Kazakhstan's public CGS (DAMU) illustrates how poorly designed schemes can prove costly and add limited

value. DAMU faced numerous operational challenges stemming from initial weak design features (sectoral restrictions, free charge policies, complex approval and claims settlement procedures).

- **Consideration of the entire A2F ecosystem is critical when rolling out CGSs**. Malaysia's CGC and South Korea's KODIT, for example, benefit from elaborate SME support ecosystems that include financial and business development services, rating schemes and a broad range of other support services.

- **Establishment of proper legal and regulatory frameworks can improve the overall environment for CGSs** by establishing capital adequacy requirements, adequate solvency ratios and criteria for portfolio evaluation and provisions. Supervisory control is often the responsibility of the Central Bank (e.g. Pakistan CGS) or a central government ministry (e.g. KODIT). Insufficient regulatory oversight over large scale guarantee schemes like, for example, CGTMSE can prove challenging. Best practices encourage supervisory responsibilities to be assigned to one entity - preferably the financial sector supervisor.

- **Smaller innovative CGSs offer valuable insights into niche CGSs** - The NGO-funded value chain CGS in Tanzania (AGRA) and the USAID-supported municipal guarantee funds in the Kyrgyz Republic offer interesting examples of specialized schemes addressing specific credit gaps in narrow market segments. AGRA's specialized value chain CGS successfully facilitates commercial bank lending to associations of agro-dealers who in turn provide inputs to local farmers. Such schemes are operated as financially sustainable operations but have clear development mandates and are typically accompanied by significant capacity building and value chain support. Municipal guarantees in Kyrgyz Republic also provide unique examples of municipality-funded schemes that operate in a financially sustainable way and involve financial institutions in the ownership and capitalization of the fund.

Overall, experiences from these vastly different CGSs and best practises suggest that positive outcomes call for well designed, well-funded and well-implemented schemes that take a longer-term view and carefully navigate between development and financial sustainability objectives.

This paper is intended to serve as the basis for discussion and upcoming dialogue on future MSME credit guarantee schemes with key stakeholders including the NRB, Ministry of Finance (MOF), existing loan guarantee initiatives (including DCGF), donors, private sector, and other participants. To facilitate future dialogue, we have included a brief overview of the two options for scaling CGS in Nepal including the obvious benefits and challenges of both. The first option looks at the expansion of CGSs through the existing DCGF and the second suggests establishing a separate legal guarantee entity with private sector participation from banks and the Central Bank and potential donors. Given international experiences and prevailing best practices, an in-depth look at existing guarantee arrangements and potential implementing organizations is certainly warranted in order to ascertain the suitability and/or readiness of institutions to take on larger, robust and market-driven MSME guarantee schemes in Nepal.

Ultimately, the optimal CGS will be one that can effectively catalyse commercial financing to the MSME sector and contribute to long lasting changes in the banking sector. Moving forward, it is our hope that this paper provides stakeholders with key insights and global best practices on designing and implementing appropriate CGSs. In collaboration with key stakeholders like NRB and the MOF, we look forward to jumpstarting an active dialogue that addresses critical next steps and the way forward for Nepal.

1. Background

There is growing support within the financial and development communities of Nepal to facilitate access to finance for micro, small and medium enterprises (MSMEs) through the scaling of credit guarantees. Despite rapid growth in the financial sector, much of the country's MSMEs - especially the rural areas - still lack access to financial services. Most banks focus on large corporates and ignore the lower income segments of the economy due to higher transactions costs, lack of collateral as well as proximity constraints. In spite of numerous financial inclusion initiatives on the part of government and donors, access to formal credit for MSMEs remains a key challenge.

Given these challenges, UKaid Sakchyam Access to Finance Programme (Sakchyam) is presenting this paper to build the case for scaling credit guarantee schemes in Nepal. In 2014, Sakchyam prepared a feasibility assessment underscoring the importance of establishing a standalone MSME credit guarantee scheme (CGS) in Nepal and opted, in the interim, to develop its own CGSs with a handful of participating banks. Although these programs are still relatively young, they have proven successful in stimulating the flow of capital to key sectors with minimal claims to date. Still, running multiple guarantee funds is not a sustainable solution given the tenure of such programmes.

As a result, a number of options could be explored to expand CGSs in Nepal, including the establishment of a separate legal guarantee entity with private sector participation from banks or the expansion of CGSs through the existing DCGF. These initiatives are building off momentum set forth by NRB's recent monetary policy 2017/2018, stressing the importance of the productive sectors and expansion of formal credit by banks and financial institutions (BFIs) to agriculture, energy, tourism, productive enterprises and SMEs. The requirement that commercial banks lend 25% of the portfolio to priority sectors and that an additional 5% be focused on deprived sector lending underscores the urgency for commercial banks to change strategic and operational behaviours and scale lending to new market segments on a more permanent basis.

The process of designing and implementing new CGSs requires careful analysis of the MSME market segment, the financial sector and legal and regulatory landscape in order to understand the needs and constraints of key market segments. Analysing comparable CGSs and identifying best practices are also informative for the design process. The primary purpose of this paper is to present the key access to finance (A2F) challenges facing Nepal and build a strong case for institutionalizing CGSs according to the best practices and criteria for success extracted from eight comparable CGSs worldwide. The paper is structured as follows:

Section I - explains the rationale for using CGSs and looks at the various institutional models and design features (delivery approaches, coverage, eligibility criteria, procedures, pricing, claims settlements) that can influence the success of CGSs.

Section II - provides a snapshot of Nepal's macroeconomic developments, MSME and financial sector landscapes and A2F enabling environment to provide the country context for discussions on scaling CGSs.

Section III - presents eight descriptive studies of different CGSs from around the world (Pakistan, South Korea, India, Kazakhstan, Tanzania, Sri Lanka, Malaysia, and Kyrgyz Republic), in order to extract lessons learned and criteria for success when considering new/ scale up for Nepal.

Section IV - provides an overview of globally accepted principles that guide the design and implementation of CGSs incorporating key takeaways from the various cases in Section III.

The paper is intended to serve as the basis for discussion and upcoming dialogue on future MSME credit guarantee schemes with key stakeholders including the NRB, Ministry of Finance (MOF), existing loan guarantee initiatives (including DCGC), donors, private sector, and other participants.

2. Section I - Rationale for credit guarantee schemes

Addressing the (M)SME Financing GAP

It is common knowledge that small and medium sized enterprises (SMEs) play a central role in job creation, innovation, social cohesion, and economic growth especially in developing countries. The World Bank estimates that formal SMEs contribute up to 60% of total employment and up to 40% of GDP in emerging economies.[1] In most developing countries, the private sector is dominated by SMEs with the majority of people either directly employed or actually operating SMEs. Despite their importance, however, SMEs continue to face operational and growth constraints, and access to affordable finance is often regarded as the primary constraint.

Without access to loans, such businesses have difficulties starting, operating and expanding their businesses. In emerging markets, between 58-68% of formal SMEs are either unserved or underserved by financial institutions with the total credit gap estimated between 0.9 trillion -1.1 trillion.[2] The financing gap is even greater when including micro and informal businesses. In fact, a recent World Bank Enterprise Survey discovered that the smaller the firm, the less likely they are to have access to capital and the more likely they are to turn to the informal sector.[3] The IFC Enterprise Finance Gap Database estimates that 45-55% of MSMEs in developing economies identify access to finance (A2F) as a key operational constraint.[4]

Explanations for (M)SME A2F vary by country but the basic constraints are universal: MSMEs cannot provide sufficient collateral or satisfactory information/data (asymmetry of information) to compensate lenders for the perceived higher risk of potential default. Furthermore, lenders offer generic loan products with rigid repayment schedules using lending practices that often are not suitable to MSMEs. Lastly, higher volumes of smaller lower value loans are often perceived as unprofitable given the fixed transaction costs and relatively higher origination and monitoring costs.

[1] World Bank (2015); *Brief on Small and Medium Enterprises Finance.*
[2] IFC Enterprise Finance Gap Database, IFC, assessed 10/2015.
[3] World Bank Group (2010); *Enterprise Surveys – What Business Experience.*
[4] Stein, Ardic and Hommes (2013); *Closing the Credit Gap for Informal Micro, Small, and Medium Enterprises*, IFC Advisory Services.

Justification for Credit Guarantee Schemes (CGS)

"Credit Guarantee Schemes are one of the most market-friendly types of interventions, as private financial institutions usually retain a primary role in screening of borrowers and final lending decisions" – IFC[5]

Governments and donor institutions have numerous instruments at their disposal to address A2F. But, policy instruments, like CGSs, are increasingly preferred as less distortionary market-friendly options that can successfully leverage private sector funding for MSMEs.[6] By reducing market entry risks for lenders, CGSs encourage financial service providers (FSPs) to invest in new MSME lending models that are sustainable over the long run. Guarantees enable banks to better understand the creditworthiness of MSMEs without forcing them to incur the initial risks involved.

Credit Guarantee Schemes – How do they work?

CGSs do not provide direct lending to borrowers but instead focus on facilitating A2F between lenders and borrowers by alleviating the restrictive collateral requirements. In short, credit guarantees work like personal guarantees provided by a guarantor to pay all, or part, of the loan if the borrower defaults. The main actors involved in CGSs include the guarantor (separate company or a dedicated public-sector entity set up by government or a donor); the lender (typically a financial service provider) and the borrower. Governments are involved as regulators (Central Bank, Ministry) but can also play a direct role through financial support, management or providing counter-guarantees.

See Appendix A for an overview of the pros and cons of CGSs.

Credit Guarantee Schemes – Typologies & operational Design features

There are numerous CGS institutional delivery models that include a broad range of providers including government, NGOs, donors, and development finance institutions. An overview of organizational and operational design features is included below.

[5] International Finance Corporation and Global Partnership for Financial Inclusion (2011); *G-20 SME Finance Policy Guide*.
[6] World Bank (2015); *Principles for Public Credit Guarantee Schemes for SME - A Quick Guide on the Principles for the Design and Implementation and Evaluation of a Public CGS*.

ORGANIZATIONAL AND DESIGN FEATURES	
OBJECTIVE	Objectives are clearly stated in the CGS mission statement and can cover broad objectives (economic growth, job creation, poverty alleviation) or narrow objectives that target key market segments, loan products and/or geographical areas of the country. Objectives will shape the eligibility criteria.
LEGAL BASIS[8]	CGS require clearly defined legal frameworks that establish the rules and responsibilities of stakeholders involved. Depending on classification of schemes, such frameworks clarify ownership policies, accountability and representation. CGSs are typically classified as follows: (1.) Guarantee companies (subject law applicable to commercial businesses). In such cases, shareholders agree to provide private and/or public permanent equity. Examples include: mutual companies (see below) initiated by groups of businesses to provide guarantees to members or commercial companies/institutions set up as limited liability or public limited companies with initial capital provided by private sector, public sources or donors. In such cases, well-endowed funds are critical. Example: Credit Guarantee Corporation Malaysia Berhad (2.) Guarantee programs set up within legal framework of a public institution according to regulations governed by political decisions. Guarantee funds consist of "limited and temporary public resources administered as autonomous asset"[7] and earmarked for specific purposes. These programmes are managed by specialized public institutions including public agencies, development bank or a public financial institution that rely on public budgets to support the guarantee funds. Example: India's CGTMSE and Brazil's SEBRAE CGS run by its development agency for small enterprises. Other guarantee programs are run in administrations and managed by public authorities (where no company is actually established). Example: US Small Business Administration.
OWNERSHIP/ MANAGEMENT[9]	Ownership models fall into 3 main categories: (1.) Public - 100% ownership by government; typically, the result of a government initiatives to address MSME development and specific A2F constraints. Public CGSs are generally managed by an independent entity or administrative unit of government. Example: India's CGTFMSE CGS; South Korea's KODIT

[7] GIZ Study; SMEs' Credit Guarantee Schemes in Developing and Emerging Economies (p.29)
[8] GIZ Study; SMEs' Credit Guarantee Schemes in Developing and Emerging Economies (p.29)
[9] OECD (2013); *SME Entrepreneurship Financing: The Role of Credit Guarantee Schemes and Mutual Guarantee Societies in supporting finance for small and medium sized enterprises, Final Report.*

ORGANIZATIONAL AND DESIGN FEATURES	
	(2.) Public/Private Hybrid (majority public) - Hybrid schemes typically involve government and private sector entities (namely financial institutions) as minority shareholders. These hybrids are often managed by development banks, SME agencies, or public financial institutions with the financial responsibility of the guarantee business separated from the equity of the institution. Example: Malaysia's CGC,
	(3.) Public/Private Hybrid (majority private) - Schemes are characterized by direct involvement by private sector in funding and management of the scheme. Government is limited to a regulatory and supervisory role and, if necessary, provision of financial support (direct funding or counter- guarantees). Example: mutual guarantee schemes Such schemes typically involve "groups" of borrowers that provide collective guarantee to their members. Members participate in management and capital formation of the company. Such guarantees schemes are most common in Europe and South America but mutual credit guarantee schemes are increasingly being piloted in other countries. Example: India – UNIDO's collaboration with SIDBI to establish a fully functional mutual credit guarantee fund in Jaipur, and Ambur, India.[10]
FUNDING - CAPITALIZATION OF FUND	Funded schemes keep sums of money in bank accounts or invested in another way. Fund's source can include contributions from Central Bank, development agencies and donors, banks, SME promotion agencies, or businesses. Fees charged for guarantees are then added to the fund and, in turn, funds get depleted when claims are made. Other schemes are unfunded with payments coming directly from government budgets Examples: USAID, DCA guarantees. Fund size will depend on anticipated demand, delivery approach, availability of funding and leverage expectations (amounts of loans extended/capital of guarantee fund).
GUARANTEE COVERAGE	Risk sharing arrangements are typically defined as % of loan guaranteed by the guarantor versus the lender. Ratios depend on delivery approaches (see below) and risk profiles of targeted borrower. Coverage ratios for individual guarantees are typically higher (60-80%) as guarantors take on more risk being directly involved in the initial screening process. Coverage ratios on loan portfolio guarantees are likely to be lower (50-60%) due to lender controlling much of the screening process[11]. Ultimately, coverage ratios should factor in ultimate borrower risk and utilization of the scheme.

[10] Unido, Credit Guarantee Schemes for Small Enterprises
[11] Deelen and Molenaar (2004); *Guarantee Funds for Small Enterprises - A Manual for Guarantee Fund Managers,* International Labor Organization.

ORGANIZATIONAL AND DESIGN FEATURES	
ELIGIBILITY CRITERIA	Borrowers – CGS's objectives dictate eligibility criteria. Eligibility criteria define the target group either as a specific sector, business type, cluster or group of borrowers or particular needs (investment capital or working capital), or business size (assets/turnover/employees). Eligibility criteria influence credit risk, default rates and operational costs of the CGS. Financial Service Providers (FSP) - Due diligence of FPSs is critical especially for portfolio CGS schemes. FSPs are typically evaluated according to: branch network, commitment to SMEs, staff capacity, risk management practices and lending procedures.
DELIVERY APPROACH	Individual/Retail - Guarantor examines individual loan applications on a case-by-case basis, either before (ex-ante), after (ex-poste) or at the same time as the partner financial institution (PFIs) assess the application. This approach assures control over eligibility, and risk factors. Typically, such approaches are not suitable for micro-enterprises given high costs of both guarantor/lender processing numerous small applications. Example: CGTFMSE, KODIT Loan Portfolio - Approach entails automatic coverage of a pre-defined volume of loans agreed by a lender to his clients subject to a set of criteria (size, purpose of loan, borrower type) imposed by the guarantor and stipulated in the guarantee agreement. Guarantors do not screen the credentials of each borrower individually. Instead, guarantor receive regular reports on operations. Example: Pakistan's CGS Institutional/Wholesale - Guarantor provides counter-guarantees for non-banking intermediaries (e.g. microfinance institutions, NGOs) that allow them to access funds from commercial banks and on-lend to target borrowers. Guarantor indirectly facilitates A2F. Example: DFID/Pakistan's Microcredit Guarantee Facility; Accion Latin American Bridge Fund, USAID/DCA, Grameen Foundation. Counter-guarantees - Some CGS involve a higher level secondary guarantors (public institutions, multilateral and/or bilateral organizations) that provide counter-guarantees. In such cases the secondary guarantor is not involved in the approval of loans but simply agrees to participate in the risk. These types of arrangements are more common in developed countries. Examples: European Investment Fund provides counter guarantees for CGS in Europe. The Japanese Bank for International Cooperation provides counter guarantees for guarantees provided by the country's Export Credit Agency. Developing country examples include FNG in Columbia which offers counter guarantees for regional funds.
TERMS AND CONDITIONS	Terms and conditions covers maximum loan sizes, durations and other relevant terms and conditions of the guarantee arrangement.

ORGANIZATIONAL AND DESIGN FEATURES	
PROCESS	CGSs have different procedures covering the origination and application process. Regardless, procedures should clarify responsibilities of both guarantors and lenders in the evaluation of applications and the monitoring and managing of loans (avoiding duplication of efforts and costs).
PRICING	CGGs typically charge fees for the service of providing a guarantee. In theory, fees cover both the administration costs and perceived default risk. These fees can be charged directly to the borrower, to the lender, or both - either upfront or as annual fees.
CLAIMS AND RECOVERY PROCEDURES	Claims processing procedures need to be clearly stated. Usually, guarantees are called in after a specified number of days following the first payment in arrears. Once claims are properly validated, guarantor pay out within a specified time period.
OTHER ACTIVITIES	Other activities might include providing capacity building technical assistance to lenders or business development assistance (financial literacy, business skills, value chain support etc.) to borrowers.
REGULATORY AND SUPERVISORY FRAMEWORK	A minimum regulatory and supervisory framework for CGS is necessary given that guarantees must be safe and liquid if called on. Schemes are either fall under rules applicable to financial institutions or are subject to special legislation. Even if schemes are not classified as financial entities, CGSs are still regarded as "credit intermediaries" and prudential standards and supervision should still apply. For this reason, appropriate regulatory frameworks should ensure: • Performance of activities/duties explicitly mandated • Adequate governance structures in place • Minimum capital adequacy requirements • Safety of investments of the guarantee fund, • Adequate leverage solvency ratios • Adequate risk management architecture • Mandatory accounting standards Selection of supervisor will depend on legal framework and country context. Supervisory control is usually the responsibility of the Central Bank (e.g. Pakistan CGS) or a central government ministry (e.g. KODIT). In general, regulators improve the overall environment for CGSs by establishing capital adequacy requirements, adequate solvency ratios and criteria for portfolio evaluation and provisions. Banking supervisors are considered most qualified to oversee guarantee schemes.

3. Section II - Access to Finance Landscape in Nepal

Selecting and designing optimal SME financing interventions is highly dependent on the needs and constraints that MSMEs face in the individual country. Comprehensive demand studies need to address questions including: What types of businesses are facing the biggest A2F constraints? Are these businesses creditworthy? What type of finance do they require to either operate or expand their businesses? Do banks have loanable funds but merely lack the motivation to lend down-market? Are there enabling environment constraints that impede MSMEs from accessing finance? Answers to such questions will influence the institutional structure and design of CGSs.

In order to contextualize future discussions regarding optimal CGSs, a brief review of Nepal's A2F landscape is included below.

3.1 Overview of key Macroeconomic Developments

Moderate growth	A significant turnaround in growth rates of 0.01% in FY 2016 to 6.9% in FY 2017 was attributed to improved harvests, trade normalization, momentum in earthquake reconstruction work and improved control electricity supplies.12 World Bank economic growth expectations are for moderate growth averaging 4.5% over next 2 fiscal years.[13]
Political environment	Political environment has improved but remains unpredictable. Current government was only recently sworn in as part of a power sharing arrangement among coalition partners. However, progress to date has been positive and appropriate steps are being taken to build a stable political system.[14] Nepal will be holding general elections in November and December, 2017. During that time, elections to seven state assemblies will also be held in a continued effort to build a more decentralized and federal system. Although Nepal has officially embraced a federalist government structure, the decentralization of governance remains a challenge particularly with regard to raising and allocating revenues at both local, provincial and national levels.
Poverty indicators	Most poverty indicators show improvement, particularly in rural areas where farm and non-farm incomes grew largely due to increases in remittance receipts.[15]
Remittance dependent	Remittances continue to make up a very large % of GDP and plays a big role in Nepal's economic development.[16] The share of remittances to GDP increased by 4.6% to NPR 695.4 billion to 26.8% in FY 2017. However, the remittances growth rate declined from 7.7% (FY 2016).[17] The slower rise in remittances, will continue to put pressure on financial sector liquidity.

[12] Asian Development Bank (2017); *Macroeconomic Update, Nepal*, Volume. 5, No.1
[13] World bank (2017); *Nepal Development Update, Fiscal Architecture for Federal Nepal.*
[14] World bank (2017); *Nepal Development Update, Fiscal Architecture for Federal Nepal.*
[15] Ibid
[16] FinMark Trust, Cenfri and UNCDF (2016); *Making Access Possible Nepal, Detailed Country Report.*
[17] Asian Development Bank (September 2017); *Macroeconomic Update, Nepal.*

Mismatch	The ensuing mismatch in deposit collection and credit disbursements put banks under pressure and forced the Central Bank to provide temporary relief to increase the availability of loanable funds.[18] NRB has since withdrawn these temporary relief measures and instead allows financial institutions to include money raised through debentures as deposits as well as deduct refinanced loans.
Expansion in credit	Over the past few years, Nepal's financial system has experienced rapid expansion (mostly caused by an influx of remittances) with domestic credit allocated to private sector far exceeding the regional average growth rate for South Asia. In the first half of 2017, Nepal continued to experience rapid credit growth pushing private sector growth to a seven year high of 31%.[19] Recent World Bank Doing Business Ratings completed in June 2017 accessing credit on the basis of the country's credit reporting systems and effectiveness of collateral and bankruptcy laws improved substantially. This was largely the result of newly implemented laws on secured transactions, a functional secured transactions system and a centralized, notice-based collateral registry. [20] Alternate Credit Scoring Models based on psychometric lending are also transforming lending allowing banks to tap into alternate sources of data (online social networks, mobile, and psychometrics) thereby filling a critical information gap when traditional credit information is limited or unavailable. Just recently, Sakycham facilitated the partnership between Entrepreneurial Finance Lab and two Nepalese banks to launch such alternative scoring tools.
Poor infrastructure	Lack of infrastructure (electrical power, transportation) remains a significant constraint on economic growth and development.[21]

3.2 Micro, Small and Medium sized enterprises Sector Landscape

To date, the identified target group for future guarantees in Nepal is still broadly defined as MSMEs (see official definitions below), but a more granular demand study of the segment is warranted. Such an analysis is beyond the scope of this discussion paper, but the subsection below highlights some key defining features, behaviours, financial needs and business constraints of the MSME sector to date.

Classification Challenges

Regardless of a business's classification (either micro, medium or small), suitable candidates for CGSs should be creditworthy, having sufficient repayment capacity regardless of their accessibility to collateral. Small-scale subsistence operations focused on generating income to survive might require finance but are perhaps better suited for grants. On the other extreme, businesses operating stable and profitable businesses that require different types of loans or payment services might be bank-

[18] Temporary relief allowed banks to calculate Core Capital and Deposit ratios by deducting 50% of loans extended to productive sectors.
[19] International Monetary Fund (2017); *IMF Country Report - Nepal*
[20] World Bank (2017); *Doing Business 2018 – Reforming to Create Jobs, Nepal*
[21] FinMark Trust, Cenfri and UNCDF (2016); *Making Access Possible Nepal, Detailed Country Report.*

worthy, but not necessarily guarantee worthy as they have access to formal finance under normal conditions. These are important considerations when defining target markets and establishing eligibility criteria.

MSME Definitions - According to the recently enacted Industrial Enterprises Act 2016 MSMEs are defined as follows:

Micro	Fixed Assets up to NPR 500,000 (excluding land and building); turnover NPR 2 million and fewer than 10 employees.
Small	Fixed Assets less than NPR 100 million (including land and building); turnover N/A and Employees - N/A.
Medium	Fixed Assets more than NPR 100 million but less than NPR 250 million (including land and building); Turnover - N/A; employees - N/A

For purposes of market segmentation and identification of suitable A2F interventions, such classifications present particular challenges. Definitions do not consider company turnover and requested loan amounts for small and medium businesses and assume all businesses with less than 10 employees are microenterprises. Using "MSME" classifications in Nepal can also be misleading as most of the segment is made up of informal microenterprises which have starkly different characteristics and financial needs to that of small and medium businesses. On the other hand, within the MSME segment, there are also many high performing micro businesses, often called "MFI graduates," [22] that have significant growth potential but limited access to deeper and broader financial services.

CGS designs will need to consider the unique differences in behaviours, needs, constraints, and functionality of micro, small and medium businesses in order to isolate the key target markets and formulate appropriate eligibility criteria for future guarantees.

Informal MSMES (Largely made up of Micro-Enterprises) represent a large part of Nepal's Economy

- According to the Nepal Economic Survey 2072/73[23] there were 758 large businesses; 1,387 medium businesses; 3808 small businesses registered (with Department of Industries) and 380,182 micro enterprises. Approximately 183,006 MSMEs are registered.
- Nepal's MSME sector (largely informal) contributes approximately 38% of the country's GDP[24] and is primarily made up of microenterprises which employ approximately 2.5 million people in Nepal of which 98.6% were microenterprises; 1% small and 0.4% medium.

[22] Shankar (2016) *Bridging the "Missing Middle" between Microfinance and SME finance in South Asia*, ADB.
[23] Ministry of Finance
[24] FinMark Trust, Cenfri and UNCDF (2016); *Making Access Possible Nepal, Detailed Country Report.*

MSME's are typically family-run traditionally managed businesses engaged various business activities largely concentrated in rural areas.

- Much of the adult population of Nepal engage in diverse economic activities largely due to the fact that their main sources of income are not adequate.
- Most MSMEs are agro-based (tea, vegetables, horticulture and floriculture), forest-based or livestock-based (dairy, milk, animal husbandry) but often also active in supplemental business activities in off season including wood and metal handicrafts, carpentry, weaving, apparel and leather, tea shops, etc..[25] Approximately 77% of the total adult population is engaged directly or indirectly in farming.[26] Most MSMEs in urban areas are active in retail business, wholesale or sales. MSMEs in rural areas (68%) are largely engaged in agro-based activities. [27]
- The majority of MSMEs are small, informal family-led enterprises. Ownership and management is usually controlled by same individual and equity capital is typically limited to personal and family savings.
- Studies show there are still limited large modern capital-intensive, resource-based, import-dependent and assembly-oriented enterprises in Nepal. Instead, most small and informal sector enterprises use very simple and traditional technologies and serve a limited local market.
- The main constraints facing MSMEs are traditional management practices, low capital base, outdated production processes and poor business and marketing skills. Many face increasing competition from foreign goods and rising costs of production (neighbouring India is a low-cost producer).

MSME's play critical role in Nepal's Future Economic Development

- Recent MAP Financial Inclusion country report suggests that MSMEs represent 96% of the country's industrial establishment and contribute 83% to industrial employment generation.[28]
- The group represents 13% of the total adult population of which 57% are formal secondary education and 32% are based in urban areas.

MSME's Financial Needs

MSMEs are in need of working capital investment finance, payment services, insurance and savings products. MSMEs involved in trading require significant upfront capital to purchase inventory for trade.

- Many microenterprises access loans for consumption purposes. Others use loans to support their business activities but continue to suffer from low profit margins that limit their growth. There are also microenterprises that operate successful businesses and are clearly ready for larger loan volumes and other financial services to scale their businesses and transition to formal production-oriented small and medium businesses.
- 72% of MSMEs have access to formal financial services but use limited range of financial products. Access to credit is dominated by the informal sector.

[25] European Economic Chamber Nepal (2008) - *Overview of Nepalese Small and Medium enterprises in Nepal*
[26] FinMark Trust, Cenfri and UNCDF (2016); *Making Access Possible Nepal, Detailed Country Report.*
[27] Ibid
[28] Ibid

Demand studies should help to identify and quantify eligible creditworthy collateral-deficient businesses in need of working capital and/or investment capital. Depending on numbers, location and volumes of credit required, targeting might include broader pools of MSMEs based on asset size or employees or more specific business segments like dynamic and growth-oriented businesses or rural agro-businesses.

3.3 MSME Access to Finance Landscape

Financial System

Nepal's financial system is relatively healthy but heavily bank dominated with 28 public and private commercial banks (Class A), accounting for 79% of total banking assets, and 87% of total assets/liabilities of the formal financial system.[29] The remaining assets are held by the 40 Development Banks (Class B), 28 finance companies (Class C), 53 microfinance development banks (Class D) and a large pool of savings and credit cooperative (SACCO)s, financial non-governmental organizations (FINGOs) and MFIs. Despite banking sector's dominance, commercial banks extend only 2.5% of their total credit flow to the SME segment as of the first quarter of fiscal year 2016/2017. [30]

Most banks in Nepal show little interest in serving a wider base of lower value clients with the bulk of lending focused on their comfort zone including low risk corporate customers that are easily accessible and sufficiently collateralized. With the high cost of deposits squeezing their profits, banks will continue lending to sectors like real estate, margin lending and trading - sectors which are already overly saturated. In fact, banks are making new loans at a rate that barely cover their costs. However, with the newly increased minimum capital requirements and likely consolidation in the banking sector, it is not unlikely that banks will be forced to look to new markets to maintain minimum profitability.

MFIs and SACCOs are often better suited to lend to the micro and small enterprises given their proximity, and community knowledge but, despite support from apex institutions and wholesalers, many face capacity and management constraints and are still limited in their outreach. Financial SACCOs, accounting for more than 15% of the financial system, face similar constraints and the sector also suffers from a lack of regulations and supervision.[31]

Given the dominance of commercial banks and their ability to provide a broad range of affordable financial services at scale, their involvement in bridging the A2F gap is critical. Interventions, such as CGSs, and alternate credit scoring models (such as the psychometric lending tools being introduced through Sakchyam's assistance) that can reduce market entry risks and stimulate banks to shift down-market with new delivery and lending models and low cost flexible financial services would be optimal. MFI/Cooperatives are partially addressing the A2F needs - particularly in the rural areas - but many suffer from capacity and management constraints and are unable to offer MSMEs similar range of product that banks can. Future interventions will, however need to consider the challenges of proximity to new clients, as most banks are still concentrated in the urban and semi-urban areas.

[29] World Bank (2017*); Nepal Third Financial Sector Stability Credit DPC3*.
[30] NR- Monthly Statistics Report (as of October 2017)
[31] International Monetary Fund (2017); *IMF Country Report - Nepal*

Legal and Regulatory Framework – Banks and Credit Guarantee Schemes

Banking Sector - Legal and regulatory frameworks governing A2F cover a broad range of regulations and laws that essentially outline the rules within which financial service providers and businesses operate. The role of the regulators is to ensure that those rules are effectively supervised. In this light, the Nepal Rastra Bank (NRB) - the Central Bank of Nepal - has been successful in pushing forward the financial inclusion agenda and solidifying its role as a robust regulatory institution in the country. As per the Nepal Rastra Bank Act of 2014, the Central Bank function serves as apex institution providing oversight over the entire financial sector with authority to license, regulate and supervise BFIs. BFIs, in turn, are regulated by the BFI Act 2016 and all BFIs licensed by the NRB must adhere to this act. The NRB Act Amendment Bill (addressing bank resolution powers of the NRB), and the Bank and Financial Institutions Act – BAFIA were both designed to strengthen corporate governance of commercial banks and thereby serve to further strengthen the financial sector as well as NRB's authority and supervisory role. NRB, is however, not responsible for supervising the bulk of cooperatives providing financial services which, instead, fall under the Ministry of Cooperatives and Poverty Alleviation. Absence of effective regulation and supervision over these financial cooperatives remains a concern amongst donor communities. NRB also does not supervise DCGF which falls under supervision of the Ministry of Finance. Considering the fact that DCGF carries out functions similar to that of a financial intermediary, it is questionable if such operations should remain unsupervised by the Central Bank over the longer run. ADB recommends establishing appropriate regulatory and supervisory frameworks and argues central bank or financial system regulators to be supervisors of CGSs[32].

Overall, NRB has been largely successful in its efforts to strengthen the financial system but maintaining financial stability, strengthening supervision and regulations for MFIs and cooperatives and accelerating key financial sector reforms remains a top priority moving forward.

The Basel Committee on Banking Supervision's comprehensive reform package (BASEL III) helps to further develop resilience in the banking sector and NRB has taken steps to issue an action plan for implementation of Basel III (in simplified form) ensuring the 3 main pillars of minimum capital requirements, supervisory reviews of capital adequacy and market discipline.

Credit Guarantee Schemes - DCGF is a self-governed institutionalized entity with authorized capital of NPR 10 billion (NPR 5 billion paid-up capital) and separate funds for deposit guarantees and credit guarantees. 89.19% of its shares are held by GON, 9.9% by NRB, 0.55% by Nepal bank Limited and 0.27% by Rastriya Banijya Bank. DCGF has the statutory responsibility to perform both deposit and credit guarantees.[33] The Deposit and Credit Guarantee Fund Act, 2073 (2016) is a new law that facilitates deposit insurance and credit programs and provides a legal framework for deposit insurance, thereby allowing DCGF to operate on the basis of an improved legal framework governing its deposit and guarantee activities. [34] The recent Deposit and Credit Guarantee Fund Small and Medium Enterprise Credit Guarantee By-laws, 2016 establishes the operating guidelines of the DCGF.

General Enabling Environment Constraints - Despite much progress by government and donor to strengthen legal and regulatory environment for A2F, significant enabling environment challenges remain. See **Appendix B** for an overview of constraints.

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[32] ADB (2016); *Credit Guarantees – Challenging their role in improving access to finance in the pacific region*
[33] Deposit and Credit Guarantee Fund Act, 2073
[34] International Monetary Fund (2017); *IMF Country Report - Nepal*

Overview of A2F Constraints

Despite Nepal's large and multi-tiered banking sector, access to finance remains limited to most of the population in Nepal.

- According to the Ministry of Finance, up to 53% of the population do not have access to any form of credit.[35]
- According to recent surveys included UNCDF's recent MAP surveys, 61% of the population have access to formal financial service **but**, among that group, 25% use only **one type of financial service** (savings, payment credit, or insurance), 21% use **only** informal financial services and 18% are completely excluded from formal and informal financial services.[36] More importantly, 29% of adults borrow from informal institutions and only 18% borrow from a formal institution.[37]
- According the UNCDF's survey, the top 5 sources for taking loans were: money lenders (21%), banks including MFIs (10%), cooperatives (9%), savings groups (8%) and family and friends (8%).[38]
- For MSMEs (as defined in the UNCDF's MAP 2016 country report), 72% have access to formal financial services; 12% are excluded and informal credit exceeds informal credit.
- 48% of farmers in Nepal's largely agriculture-based economy are excluded from any form of A2F. 52% have some access to finance but tend to prefer informal sector. Formal credit is more popular with trading (as opposed to subsistence) farmers.

Despite efforts by government and donors to subsidize loans and stimulate MSME lending through formal providers, informal channels seem to dominate. Informal banking is widespread in both rural and urban centres of Nepal, particularly due to the lack of regulation and monitoring. Although informal credit is more expensive, many MSMEs seem to prefer informal to formal channels.[39] Agent based financial services providers (utilizing digital channels) are still nascent with the exception of remittances, but momentum in branchless (POS) banking, internet banking, 3rd party remittance-based model for MFSs and mobile banking is gaining momentum.

A closer look at the specific access barriers facing MSMEs and FSPs is necessary to address the A2F gap. A detailed overview of demand, supply side A2F constraints are summarized in **Appendix C**.

MSMEs need working capital and investment finance to maintain and scale their businesses. But access to formal finance - especially of credit - remains exceptionally low. Formal financial service will require strong incentives to lend to these new market segments.

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[35] Ministry of Finance, Nepal (2014/2015)

[36] FinMark Trust, Cenfri and UNCDF (2016); *Making Access Possible Nepal, Detailed Country Report.*

[37] FinMark Trust, Cenfri and UNCDF (2014); *Making Access to Finance Possible (MAP)- Financial Inclusion Country Report.*

[38] Ibid.

[39] MAP's 2015 qualitative research indicates MFIs charge interest from 18-36%.

Review of existing SME access to Finance Interventions

In the past, the government of Nepal (GON) has engaged in numerous supply side policy initiatives addressing financial inclusion and A2F. Such initiatives include:

- **NRB's deprived sector lending:** Deprived sector lending (applying to A, B and C institutions) requires 4-5% of loan portfolios to be allocated to "deprived sectors" which constitute low-income, socially deprived women of lower castes, disabled, and small and marginal farmers.
- **Mandatory priority sector lending requirement:** Mandatory lending requirement increases lending to the priority sectors of agriculture and energy and other areas (25% of total loan portfolio as of 2017).
- **Establishment of FINGOS (issued licenses by NRB in 1998):** Licenses were issued to FINGOs to improve outreach of financial institutions in rural areas.
- **Establishment of rural self-reliance fund:** The Rural Self Reliance Fund - a state-owned wholesale lender to MFIs - providing access to formal finance for MFIs to on-lend to micro and small enterprises in rural areas.
- **Promoting alternate delivery channels:** NRB recently established a payment and settlement department to "formalize" NBFIs involved in financial services, mainly those providing services through alternate delivery channels such as mobile phones and branchless banking. NRB also issued directives aimed at MFIs providing guidelines for branchless banking and new regulations for mobile banking interoperability ensuring maximum outreach. Sakchyam is supporting this department in the rollout of a Real Time Gross Settlement System (RTGS) and a Retail Payments Switch to modernize payment systems.
- **Establishment of deposit and credit guarantee fund:** Establishing DCGF as primary institution in Nepal issuing credit guarantees covering priority sector loans and SME loans extended to agriculture, industry and services and livestock.
- **Promoting branch expansion outside of Kathmandu valley:** Promoting branch expansion through liberal licensing policies to open MFIs in unbanked areas, and mandatory branch expansion in villages prior to opening in Kathmandu, and interest free loans to BFIs to extend banking in rural areas.

Nepal's longer-term strategy (as discussed in the recent "Envisioning Nepal 2030" seminar) [40] builds on past progress and calls attention to key growth drivers (youth, tourism and agriculture). Nepal's roadmap for financial inclusion is a work in progress but hopes to provide a policy framework to coordinate initiatives being made by government and development communities.

As is often the case, government initiatives adequately address the symptoms of A2F challenges, but often overlook the root causes behind particular financing gaps. Arguably, interventions that change

[40] 'Envisioning Nepal 2030', which was convened by the National Planning Commission on 28 March 2016, formed an important landmark in the process. This initial engagement included international development experts, development partners, policy makers and representatives of civil society

lending behaviors and catalyze long lasting change by stimulating lending to key market segments in sustainable and profitable ways can be more effective.

Current donor initiatives addressing A2F and financial inclusion include:

Credit

- DFID: Sakchyam A2F Programme – Financial Sector Development for SMEs/poor/Value Chain Financing
- UNCDF/Danida: A2F project – agriculture and rural finance
- ADB: Capital Markets and Infrastructure Finance Support Project – Infrastructure
- GTZ: Inclusive Development of the Economy (INCLUDE)

Payment Systems

- DFID: Sakchyam A2F Programme

Risk Mitigation

- ADB: Raising Income of Small and Medium Farmer's Project – Small and Medium Farmers

Strengthen Local FSPS

- DFID: Sakchyam A2F Programme
- ADB: Improving A2F Sector Development Program – Strengthen Microfinance Sector – Poor and Low-Income population.

National Governance

- ADB: Rural Finance Sector Development Cluster Program – Improve Rural Finance/Regulatory Framework

Branchless Banking and Mobile Money

- DFID: Sakchyam A2F Programme

Credit Guarantees

- USAID/DCA: $ 5 mln. Loan Portfolio Guarantee with Laxmi Bank
- DFID: Sakchyam A2F Programme Loan Guarantees Agreements with Bank of Kathmandu, Laxmi Bank, Prabhu Bank and NIC Asia totalling $ 32 million.

Such donor initiatives continue to address various aspects of the A2F challenges in Nepal, but the financing gap, particularly for "MFI graduates" and SMEs, remains significant. Despite ongoing government and donor-led efforts addressing financial inclusion, there is clearly a need to scale innovative market friendly instruments like CGSs that, if well-designed, well-funded and properly implemented could be highly effective at addressing the access to formal credit gap for MSMEs.

4. Section III - Review of Comparable Credit Guarantee Schemes

Credit guarantee schemes throughout the world differ in their design. Moreover, design choices regarding management and governance structures, operations, and guarantee features often determine the success and financial sustainability of such schemes. This section presents eight credit guarantee schemes that shed light on the successes and pitfalls of CGSs in such countries as Pakistan, India, South Korea, Malaysia, Sri Lanka, Tanzania, Kazakhstan and Kyrgyzstan. The schemes vary in their missions and cover a wide range of institutional delivery models, and design features.

The cases are presented as descriptive snapshots and do not attempt to measure and compare performance indicators across schemes. Sources used include available literature on credit guarantee schemes, internal documents/annual reports, project documentation, and various donor studies.[41]

Comparison of Credit Guarantee Schemes and takeaways for Nepal

4.1 Case 1. Pakistan's Credit Guarantee Scheme for Small and Rural Enterprises: A successful donor funded (DFID) guarantee scheme operated in collaboration with the Central Bank

Pakistan's Credit Guarantee Scheme for Small and Rural Enterprises (CGS) was launched in 2010 by the central bank - State Bank of Pakistan (SBP) - in collaboration with the government and UK's Department for International Development (DFID). The scheme is a good example of a well-designed donor-funded CGS operating in collaboration with a central bank that addresses the country's critical access to finance constraints for farmers, micro and small businesses in Pakistan.

Background: Pakistan faces similar access to formal finance challenges to that of Nepal. According to the ADB, only a little over 10% of Pakistan's adult population have accounts with formal financial institutions.42 The country's total bank lending to SMEs totals only 4.7% and most of its SMEs rely on their own sources to satisfy their working capital and investment needs. Pakistan's microfinance sector is still limited in outreach and scope, but its branchless banking landscape is highly developed, putting Pakistan at the forefront of digital payments and branchless banking. Nevertheless, formal financial inclusion remains a top priority of SBP's financial sector development strategy and the launching of CGSs was considered critical to reviving economic and business activities in especially in the rural areas of the country.[43]

Description: Pakistan's CGS issues loan portfolio guarantees with select partner financial institutions (PFIs) including banks, MFIs and leasing companies. The CGS targets low-end small agricultural borrowers using guarantee coverage of 40-60% (depending on value of collateral offered). Initially, eligibility criteria specified eligible borrowers on the basis of clusters (e.g. fisheries, retail, agricultural services, etc), but such target market restrictions were gradually phased out. Recent eligibility criteria adjustments require a minimum allocation (60%) to start-ups, women owned businesses and small and rural enterprises in under-served areas of Pakistan. CGS also includes a wholesale Microcredit Guarantee Facility (MCGF) that provides funding for on-lending to microfinance clients across Pakistan.[44]

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[41] Findings were not based on actual interviews or field visits. The author made a best effort to gather the most recent and relevant data but encountered certain limitations with accessing up to date information in certain countries.

[42] Asian Development Bank Country Partnership Strategy (2015); Pakistan 2015-2019.

[43] United Nations Economic and Social Commission for Asia and the Pacific (UNESCAP) First High-Level Follow-up Dialogue on Financing for Development in Asia and the Pacific (2016); Country Paper – Pakistan.

[44] DFID (2015); Annual Review, Financial Inclusion Programme.

The CGS has a well-established governance structure founded on a clear separation of strategic oversight, daily management, and fund management responsibilities. The CGS consists of a Credit Guarantee Office - established as a unit of the Department of Development Finance Support - that serves as the operational arm of the fund. A Technical Committee consisting of representatives from donors, central bank and the Bank Association is responsible for strategic matters as well as performance reviews.

As of 03/2016, utilization was up to 72%, with participating banks issuing loans of Rs. 6,328 million and facilitating more than 16,000 new SME borrowers.[45] Returns on both the microfinance facility and the CGS have continued to increase over the years. Much of the funds disbursed to SBP are still available as limited claims on CGS fund has been made.[46]

Key Design Features	
Guarantee Coverage	• 40-60% on principal amounts only. 60% coverage on loans extended to start-up businesses, women, and small and rural enterprises operating in under-served areas of the country. For all other borrowers, coverage varies depending on collateral – 60% (clean); 40% collateral up to 100%; 20% collateral exceeding 100%.
Eligibility Criteria	• Micro and small enterprises and farmers with landholding (preferably new customers). • Businesses with regular and positive cash flows, borrowers should be in conformance to prudential regulations for SMEs/Agro/Micro Financing, and have a "clean" e-CIB record. • Eligibility requirements for lending to farmers was recently increased from subsistence to economic landholding. • 50% of portfolio reserved for targeted areas of the country with priority given to small farmers (landholding up to 5 acres for purchase of seed, fertilizer, etc.). • PFIs selected by Central Bank (criteria cover: financial performance, branch network and SME/rural/agricultural financing expertise.
Approach	Portfolio
Terms and conditions	• Duration for both working capital and medium-term capital needs increased to 5 years in 2013. • Guarantee limits to PFIs are allocated on a quarterly basis
Process	• Guarantor invites FSPs to participate and willing banks apply for allocation of limits. Banks are selected on the basis of pre-determined criteria and allocated a limit. • PFI submits regular reports and compliance reports to the CGS Office in the Central Bank for evaluation. • CGS Office performs post disbursement audits of select cases and submits reports to the Technical Committee of the CGS on a quarterly basis.
Pricing	• Mark-up rates are maximum KOBOR (3 month) + 300 bps.
Claims and Recovery	• Guarantor commits to processing guarantee claims of PFIs in 15 working days after receipt of complete information. • Scheme pays 50% when loan is categorized as doubtful and 50% at time of loss. • PFI continues with recovery of defaulted amount (reporting to CGO annually). • If recovered, PFI returns proportionate share of CGS to the fund. Recovery is considered – recovery of principal. Costs to recovery are not passed on to the scheme.
Supervision	• Central Bank

[45] United Nations Economic and Social Commission for Asia and the Pacific (UNESCAP) First High-Level Follow-up Dialogue on Financing for Development in Asia and the Pacific (2016); Country Paper – Pakistan.
[46] DFID (2015); Annual Review, Summary Sheet Pakistan.

Key Takeaways

CGS is an example of a relatively new and successful donor-funded scheme set up as a role model for further expansion of guarantees to other key segments (like small farmers) and future funding from government, donors and private sector. As of 2015, Government of Pakistan (GOP) approved a $50 mln. Ministry of Finance initiated CGS focused on small marginalized farmers (Credit Guarantee for Small and Marginalized Farmers – CGSMF) with landholdings of up to 5-10 acres (using 50%/50% guarantee coverage) which will be executed by the Central Bank.[47] Similar to CGS, the scheme will operate as loan portfolio guarantees and address the critical A2F needs of small farmers.[48] Currently, there are discussions underway on setting up a Credit Guarantee Fund with USD 25 million to finance small and medium businesses with funding from GOP, World Bank, USAID, DFID and the Italian Development Cooperation. [49] Key takeaways include:

OTHER DFID A2F INITIATIVES FOR MSMES IN PAKISTAN - include its Enterprise and Asset Growth Programme which works through Karandaz (a DFID created Pakistan not-for-profit company) which partners with financial institutions to develop and fund new SME products. In addition, the programme supports a Trust Fund, set up in partnership with IFC to deal with broader A2F constraints. Components of the programme include SME Credit Funds and Equity Funds providing credit to banks and leasing companies and equity to select SMEs.

Figure 1: DFID A2F Initiatives for MSMES in Pakistan

- Emphasis on repayment capacity - Pakistan's CGS clearly targets businesses engaged in higher risk market segments but still capable of repayment despite being collateral deficient.
- Outsourcing of risk assessment and monitoring to carefully selected banks - CGS portfolio guarantees include coverage ratios of 40-60% and the scheme has successfully balanced risk sharing with participation of PFIs in the scheme. All PFIs are subject to careful due diligence and selection criteria.
- Utilization of dynamic limit allocation - CGS adjusts limits on a quarterly basis depending on portfolio performance. Limit allocations serve to reduce adverse selection problems on parts of banks.
- Enforcement of rapid repayment of claims - CGS claims are generally repaid within 15 days after receipt of complete information by PFI. Rapid and efficient processing and payment of claims is a key determinant in CGS's success.
- Enforcement of strict screening of partner banks - In CGS, partner banks are invited to participate and apply but approved only after careful due diligence and evaluation.
- Utilization of sector specific approaches - In Pakistan's CGS, partner banks adopted sector specific approaches by allocating specific % of the total allocated limits to specific sectors. This approach encourages banks to tailor customized product lines for specific sectors.[50]

[47] Increased coverage ratio to 75% is currently being discussed in order to increase uptake amongst PFIs.
[48] UNESCAP First High-Level Follow-up Dialogue on Financing for Development in Asia and the Pacific (2016); Country Paper – Pakistan.
[49] International, The News, (01/14/2017); State Bank helps SMES get better access to finance.
[50] State Bank of Pakistan

4.2 Case 2. India's Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE): Challenges of a Large-Scale Pro-Poor Public Guarantee Scheme

India shares a long history of government intervention promoting financial inclusion. Its banking sector is growing rapidly and is highly diversified ranging from commercial banks to small cooperative banks that serve small farmers and urban poor. Yet, despite India's extensive banking and microfinance sector, A2F remains a challenge, particularly in rural areas. In fact, only about 53% of adult population in India have bank accounts.[51]

Background: India's Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) was launched in 2000 by the Ministry of Micro, Small Enterprises and the Government of India (GOI) and the state-run development bank, Small Industries Development Bank of India (SIDBI) to operate a large-scale public-owned CGS focused on micro and small businesses in India. The Trust - owned by the Government of India (80%) and SIDBI (20%) - was initially piloted as a scheme for only state-owned commercial banks but later expanded to include large regional rural banks. Its initial uptake was gradual but since 2009, utilization has improved.[52] 72% of its partnering banks are composed of regional rural banks and public-sector banks.

INDIA'S DEPOSIT AND CREDIT GUARANTEE CORPORATION PHASED OUT CREDIT GUARANTEE ACTIVITIES IN 2003

India's Credit Guarantee Corporation, established in 1971 to guarantee loans to neglected sectors, merged with the Deposit Insurance Corporation in 1978 and eventually formed the Deposit and Credit Guarantee Corporation (DICGC). DICGC is 100% owned by the Central Bank (RBI) and provides deposit insurance (particularly for small depositors) in order to promote confidence in the system and secure financial stability. Following the establishment of CGTMSE and other similar CGSs, banks began pulled out of DICGC's credit guarantee schemes. The last claim was settled in 2003. To date, there are few (if any) entities that merge deposit insurance and credit guarantees activities under one roof.

Figure 2: India's Credit Guarantee Activities in 2003

Description: CGTMSE was designed as an individual guarantee scheme offering various coverage schemes (50-85% - depending on the kind of borrower and amounts requested) to facilitate working capital and term loans to micro and small borrowers. Eligibility criteria are broad and include start-ups, and small and micro-businesses in manufacturing and service sectors that lack collateral or third-party guarantees. PFIs use a web portal to submit loan information to the guarantor after loans have been disbursed (ex-post) and then request coverage. Only after approval and disbursal of the loan do PFIs start the online registration process. The Trust is managed out of SIDBI's corporate office which administers the fund, issues the guarantees and markets the scheme to bankers and businesses. The CGTMSE does not fall under the central bank's supervision or even the Insurance Regulatory Development Authority of India.

[51] Datwani, L. (2017); *India's Push for Financial Inclusion*, CGAP.

[52] Financial Sector Deepening Trust (FSTD*); Review of Credit Guarantee Schemes in Tanzania - Guarantee Schemes outside Tanzania (covers CGTMSE).*

Key Design Features	
Guarantee Coverage	Coverage varies per micro and small borrower ranges between 50-85%, depending on the kind of borrower and amount requested. Higher coverage granted for microenterprises and women owned businesses and loans in the north-east region of India.
Eligibility Criteria	All start-ups, micro and small enterprises in manufacturing and service sectors are eligible. New as well as existing micro and small enterprises Eligible PFIs include
Approach	Individual - Guarantee initiated after loan has been disbursed by PFIs.
Terms and conditions	collateral free loans up to INR 10 million working capital extended up to 5 years Average loan size 4.41 Lakh.
Process	On approval and disbursal of the loan, the PFI starts the online registration process and generates a unique identity number for each borrower on acceptance by CGTMSE. The PFI then pays the one-time guarantee fee against each borrower, which is transferred online to CGTMSE within 30 days of disbursal of the loan.
Pricing	PFIs get charged a one-time up-front guarantee fee of 1 – 1.5%% (depending on loan size requested). Annual service fee paid up to 0.5% for facilities < INR 500,000 and 0.75% for loans > INR 500,000. 53
Claims and Recovery	Lock in period of 18 months from date of guarantee where PFI cannot submit claims. PFI invokes guarantee within a max. of 1 year from date of account becoming NPA. Trust pays 75% (principle and interest) within 30 days. Balance paid on finalization of recovery proceedings. Amounts recovered should first be credited in full to the Trust before it can claim remaining 25% of guaranteed amount. Requirement to have lawsuits (against defaulters) be initiated before submitting a claim Online claim to be lodged within 1 year of NPA date or expiry of lock-in period (whichever is later). After submission, claim is checked and processed.
Supervision	Ministry of Micro, Small and Medium Enterprises.

[53] Miller, Calvin (2013); *Four Case Studies on Credit Guarantee Funds for Agriculture*, FAO

Key takeaways

CGTMSE is definitely unique as a public credit guarantee scheme that operates on a massive scale to provide access to finance to micro and small businesses. Despite facilitating much needed changes to the MSE sector, however, CGTMSE faces a number of operational challenges typical for such large scale pro-poor public CGS schemes. In its 2016 Annual Report, the Reserve Bank of India (RBI) expressed concern about possible overleveraging of the Trust.[54] There are concerns regarding the CGS's capacity to properly screen and evaluate risks on high volumes of loans as well as inefficiency in claim settlement procedures. Procedures for filing lawsuits (a precondition for claim submission) and a mandatory "lock-in" period of 18 months from the date of the guarantee remain problematic. Lastly, the provision that a final instalment of the claim be paid out only after recovery is time barred continues to be troublesome for PFIs. The fact that there is insufficient regulatory oversight also remains a challenge. Key takeaways include:

CGTMSE – OPERATIONAL AND FINANCIAL HIGHLIGHTS (2016-2017, all amount in INR)

- Committed corpus of the Trust increased from 2,500-7,500 crore (GOI contribution)

- Guarantee approval rates declined over last 2 years from 21,275 crore (2014-2015) to 19,931 crore (2016-2017). 46 of the 116 member lending institutions did not use guarantee facilities in 2016-2017. In total, 4,52,127 guarantees were approved worth 19,931 crore (2016-2017). Approval decline attributed to commencement in 2014 of Mudra Guarantee through NCGTC (wholly owned company of GOI).

- With claims worth 1,062 crores paid out and 67,762 guarantees outstanding, the net loss rate was 1.4%.

- Post claim settlement improved from 57 crore (2015-2016) to 125.50 crore received from recoveries in 2016-2017. On the whole, although recovery rate improved from 5.6% in previous year, 12% is still regarded as low.

- Investment income of 430 crore and 602 crore in guarantee fees alone were insufficient to cover provisions for guarantee claims of 1,126 crore but increase in recoveries to 126 crore resulted in 26.3 crore income before tax (FY 2016-2017).

Figure 3: Operational & Financial Highlights of CGTMSE

- **Utilization of graduated coverage (as opposed to blanket coverage)** - CGTMSE's provides higher coverage for microenterprises, women owned businesses and loans in the north-east region of India. Different coverage ratios allow CGTMSE to fulfil the development mandate and ensure the flow of credit to more deprived sectors.

- **Leveraging technology to improve applications processing** - CGTMSE's use of web portal allows PFIs to process applications quickly thereby ensuring efficient data entry of applications.

- **Adoption of appropriate incentive structures** - CGTMSE suffered from slow uptake in its initial years due to the requirement that PFIs disburse loans prior to submitting applications, thereby essentially saddling banks with full risk in case applications were declined.

- **Avoidance of bureaucratic and lengthy claims procedures** - If PFIs are faced with complex and non-transparent claims procedures, they will be reluctant to continue issuing new loans under the CGS.[55]

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[54] According to the RBI in its 2015 report - CGTMSE had a corpus of around Rs. 4,500 crore by the end of September 2015 against which it has given outstanding guarantees of Rs. 65,200 crore, a leverage of almost 14 times. (The Economic Times, August, 2016)

[55] Deelen and Molenaar (2004); *Guarantee Funds for Small Enterprises - A Manual for Guarantee Fund Managers,* International Labor Organization.

4.3 Case 3. Korea's Credit Guarantee Fund (KODIT): Large scale government sponsored Guarantee Agency plays a critical role in SME development.

South Korea's A2F challenges - as a developed Asian economy - differ significantly from that of Nepal. The country's multi-dimensional credit guarantee system has matured over many years through the collective efforts of government, agencies and financial institutions and is one of the largest CGSs in the world. In fact, many countries (i.e. Kazakhstan) look to KODIT for best practices while modifying and expanding their own CGSs.

Background: Korea credit guarantee fund (KODIT) was started in 1976 by the Korea Credit Guarantee Act and was the first independent public guarantee agency in Korea. It is now one of the largest credit agencies in the world with 9 regional headquarters, 106 branches (2,300 employees), 205,000 guaranteed companies and a total fund size of $4.7 billion and guarantees.[56] The total public credit guarantee system of Korea includes KODIT, Korea Technology Credit Guarantee Fund (KOTEC) and the Federation of Credit Guarantee Foundation (KOREG), a federation of 16 regional credit guarantee funds with each scheme covering different business areas. KODIT is an independent government-sponsored non-profit legal entity that provides access to credit for SMEs. Sources of funding are threefold: 45% from government, 50% from banks through mandatory donations in proportion to monthly balances) and 5%, others (including corporations).

Description: KODIT primarily issues individual loan guarantees. Eligible borrowers - at the advice of PFIs - apply directly to KODIT which screens and approves applicants on a case-by-case basis. Clearly, such large scale individual guarantee models are resource intensive, requiring significant involvement on the part of the guarantor. KODIT also offers numerous additional services supporting and improving the overall bankability of SMEs.[57] Much of KODIT's success, in fact, lies in the strong institutional mechanisms that work, in parallel to its guarantee operations, to promote SME development.

Key Design Features	
Guarantee Coverage	Coverage Ratios 70-85% (start-ups up to 100%). Coverage is differentiated by credit rating and duration of guarantee usage. For borrowers with low to no credit rating, coverage can extend to 90% while borrowers with good credit rating get a minimum of 50%.
Eligibility Criteria	All profit seeking businesses are eligible except real estate, financial services or hospitality.
Approach	Individual; Only 3 % of guaranteed are issued directly through portfolio guarantees (FSD, 2010)
Terms and conditions	Ceiling amount of USD 2.6 mln.
Process	Borrower applies directly to KODIT for a guarantee in person or online. If successful, borrower goes to bank with letter of guarantee and gets loan. Once Letter of Guarantee is issued, borrower is responsible to pay the fee which is tied to its credit rating.

[56] World Bank (10/2016); *Learning from Korea: The Story of Korean's Credit Guarantee Agency.*
[57] KODIT does operate a number of portfolio schemes but they represent a minimal % of total guarantees

Key Design Features	
Pricing	Guarantee Fee Rate: 0.5%-3.0% per annum; differentiated by credit rating and priority criteria. KODIT reduces fees by 0.1%-0.3% if the firm is innovative or engaged in green growth (OECD, 2013). For larger SMEs, an extra 0.5% is added.
Claims and Recovery	When default occurs due to loans in arrears, PFIs call on KODIT to provide guarantee obligation within 3 months after date of occurrence. KODIT reviews the case and proceeds to honour the guarantee obligation (limited to principal, agreed interest and costs and costs incurred to collect the loan). Debt collection is performed by KODIT branches.
Supervision	As government sponsored organization, KODIT is monitored and assessed by Financial Services Commission (FSC), SME Business Administration, and Ministry of Strategy and Finance.

Key Takeaways

KODIT is a good example of a well-functioning, well-funded and well-designed CGS that continues to mature and adapt to the needs of its country's SMEs. To date, KODIT is phasing out its government volume-driven interventionist approach to an approach that is more market-oriented and focused on higher growth SMEs in key sectors (e.g. high growth technology). Key takeaways include:

- Mandatory contributions from financial institutions - KODIT's arrangement whereby all banks contribute an annual % of total outstanding loans (much like donations to a foundation) into the fund is a unique revenue model that bolsters buy-in from financial institutions and ensures a steady and diverse revenue base. These contributions are based on outstanding loans and can vary depending on the status of the economy. Contributions by big corporations are also incentivized through commitments on the part of KODIT to provide guarantees to their subcontractors.[58] KODIT is financially sustainable by bank funding (without government budgets).
- Institutionalization of CGSs through independent legal and dedicated entities - Operating CGSs through independent legal entities dedicated solely to credit guarantees and SME support allows KODIT to process and handle large scale guarantee programs in a financial sustainable way. In fact, prior to KODIT being established as an independent agency Korea's

KODIT - OPERATIONAL AND FINANCIAL HIGHLIGHTS (FY 2016)

- Amount of general credit guarantees totalled USD 34,982 million - increasing by 873 million from past year. Outstanding guarantees for bank loans at end 2016 was USD 29,910 million. (85% of total outstanding guarantees).

- Default rates declined from 4.8% (2012) to 3.9% (2016).

- KODIT 's net subrogation rate increased from 2.9% (2005) to 3.2% (2006). Total debt collection decreased from USD 468 to USD 428 million in 2016.

Figure 4: Operational and Financial Highlights of KODIT

[58] Knowledge Sharing Program: Ministry of Strategy and Finance, Korea Development Institute, Korea Institute for Development Strategy and Korea Credit Guarantee Fund (2012); *Credit Guarantee and Credit Evaluation System in Kazakhstan*. Report covered KODIT to apply lessons learned for Kazakhstan.

initial credit guarantee system suffered from numerous operational challenges and moral hazard issues. Establishing an independent CGS greatly improved its ability to process and handle large scale guarantee programs.

- Employment of differentiated coverage ratios on the basis of credit ratings - KODIT's use of differentiated coverage ratios depending on credit rating implies that businesses with improved credit ratings will receive lower coverage and eventually be able to approach formal FSP without guarantees. Clearly, such a feature depends on a well-functioning credit rating system.
- Utilization of variable guarantee fees - Variable guarantee fees allow KODIT to reduce fees to priority companies that, for example, demonstrate innovation in key areas (e.g. green growth). [59]
- Linking supervision, evaluations and audit results to incentive schemes - In the case of Korea, government - through various agencies (SMBA, FSC and MOSF) - supervises management performance, guarantee performance and operations of the various credit guarantee institutions and performs audits. The results of those evaluations are used to incentivize KODIT's employees and management. [60]
- Development of strong automated credit scoring systems supporting the guarantee scheme - South Korea's various CGS all serve different customers with various credit scoring systems but all credit information is pooled, managed and supervised by the central Federation of Banks.

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[59] OECD (2013); *SME Entrepreneurship Financing: The Role of Credit Guarantee Schemes and Mutual Guarantee Societies in supporting finance for small and medium sized enterprises, Final Report.*

[60] Knowledge Sharing Program: Ministry of Strategy and Finance, Korea Development Institute, Korea Institute for Development Strategy and Korea Credit Guarantee Fund (2012); *Credit Guarantee and Credit Evaluation System in Kazakhstan*. Report covered KODIT to apply lessons learned for Kazakhstan.

4.4 Case 4. Malaysia's Credit Guarantee Corporation (CGC): Successful public - private CGS supported by the Central Bank and a consortium of financial institutions

Malaysia is well known to have one of the highest levels of financial inclusion in Southeast Asia with 92% of its adult population having bank accounts by end 2015.[61] Its success is, in large part, accredited to the numerous A2F government initiatives and a strong central bank, championing the country's financial inclusion agenda.

Background: Malaysia's Credit Guarantee Corporation (CGC) was set up in 1972 as a private limited company (a development finance institution) with 80% of its shares held by the central bank - Bank Negara Malaysia - and 20% by commercial banks. Initially, CGC functioned as traditional guarantee provider focused purely on SME outreach but later it matured into an innovative financial institution carrying out its development mandate in a financially sustainable way.

CGC - OPERATIONAL AND FINANCIAL HIGHLIGHTS (FY 2016)

- CGC approved 7,568 guarantees and financing valued at RM 4.2 billion (exceeding target by 25% from last year). Increase attributed to aggressive marketing.

- Financing/ Loan approval under portfolio guarantees was 95% within 2 days.

- Claims payment: 100 % within 10 days.

- Profits increase by 19.8% to RM 167.7 million.

- Successful outreach to 7,568 SMEs with guarantee financing totalling RM 4.2 billion.

- Improved turnaround time for payment of claims (from 10 to 5 days)

Figure 5: Operational and Financial Highlights of CGC

Description: Since its inception, CGC has launched over 40 different loan guarantee products including the Direct Access Guarantee Scheme, a Loan Fund for Hawkers and Petty Traders and numerous guarantees targeting the Islamic banking market. It has also been active in the SME Loan securitization process (bundling and selling to secondary buyers with a guarantee from CGCMB), equity funding and establishing a SME credit bureau.[62] A total of 15 Islamic banks, 17 commercial banks and 7 development financial institutions participate in CGC's guarantee schemes, providing a wide network of over 2000 branches nationwide. In total, it has provided 445,217 guarantees amounting cumulatively to $14.8 billion. CGC currently focuses on start-ups, specific sectors like green technology and intellectual property, and new growth areas like youth entrepreneurship. It also continues to maintain and improve the country's SME rating system.[63] Net loans guaranteed increased by 11.9% from last year to RM 4.5 billion at end year 2016 (mostly attributed to growth of portfolio and wholesale guarantees)[64].

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[61] World Bank Group (2017); *Financial Inclusion in Malaysia: Distilling Lessons for Other Countries.*
[62] Financial Sector Deepening Trust (FSTD); Review of Credit Guarantee Schemes in Tanzania - Guarantee Schemes outside Tanzania (covers CGC).
[63] AECM Annual Event (2014); Breaking down barriers: Guarantees, an International Perspective.
[64] Marc – Malaysian Rating Corporation Berhard (April 2017)

Design Features	
Guarantee Coverage	Coverage varies from 30-100% depending on the type of guarantee requested. Individual loans (not reviewed by financial intermediary) can be covered up to 100%
Eligibility Criteria	CGC initially focused on providing working capital and asset investment finance to small businesses in agriculture, commercial and industrial sectors, but recently expanded its target market to include medium sized companies.
Approach	Varies depending on CGS - CGC's Direct Access Guarantee Scheme, for example, allows borrowers to apply directly to the fund without first approaching a bank. 80% of guarantees are provided based on portfolio approach where SME is first evaluated by PFI.
Terms and conditions	Maximum length is 42 months Loan amount between RM 10,000-RM 10 million.
Process	Under an i-guarantee system, the borrower applies online for a guarantee; the CGC reviews the application, after which lenders are invited to bid online for the application. The scheme also provides a portal accessible to SMEs to compare available guarantee options.
Pricing	Risk adjusted pricing structure whereby fees are linked to risk profile of borrowers. Lower rating – better price. Average fee is 3.65%
Claims and Recovery	Varies
Supervision	Central Bank of Malaysia

Key Takeaways

CGC is a good example of a central bank-initiated public-private partnership (with participation from commercial banks) that fulfils a development mandate (improving bankability and credit history of SMEs) in a financially sustainable way. It is responsible for developing a comprehensive SME ecosystem that includes SME support agencies, a central credit reference information system and a robust credit bureau. The Central Bank of Malaysia - as leading champion of financial inclusion – has also played a catalytic role in the success of this public-private guarantee scheme.

CGC's successful business model is built on some unique design features:

- **Development of a broad range of suitable SME products and services** - CGC continues to develop new guarantee products (both individual and portfolio) that address the changing needs of SME borrowers.
- **Utilization of internet based portals** - CGC uses internet base portals that allow for speedy and efficient processing of applications.
- **Utilization of risk based pricing model** - CGC uses risk adjusted pricing structures whereby fees charged reflects the risk profile of the SME.

- **Delivery of additional services focused on improving bankability of SMEs** - CGC offers extensive additional capacity building services throughout its large network, strengthening the overall bankability of the borrowers.
- **Employment of a bidding system** - CGC opens the application up for bidding to banks (once approved) and announces its results on the portal.
- **Integration of rebates based on their repayment history** - CGC provides rebates in order to SMEs with good repayment records.

4.5 Case 5. Sri Lanka's Central Bank (CBSL) Credit Guarantee Schemes for SMEs: A central bank-run CGS transitions to establishing a separate independent CGS agency

MSMEs in Sri Lanka are considered the backbone of the economy, contributing approximately 75% of overall GDP. Yet, despite numerous government financial inclusion interventions, MSMEs continue to face challenges including poor managerial and technology skills and access to finance.

Background: In 1967, the Central Bank of Sri Lanka (CBSL) launched its first scheme extending guarantees to local banks lending to farmers. Since then, CBSL has broadened its role to acting as apex agency for donor assisted regional and microfinance programmes, providing refinancing and issuing credit guarantees for MSMEs. To date, CBSL offers 12 CGSs for both donor-funded schemes and government funded credit schemes.[65]

Description: The CBSL's Regional Development Department (RDD) functions as a government agent in charge of the daily operations and implementation of guarantees and regional development lending programmes. The scheme issues both individual and loan portfolio guarantees with coverage varying between 60-90% to small and medium sized enterprises mostly in the agriculture and plantation sectors.

Design Features	
Guarantee Coverage	Coverage varies with loan size 60-90% depending on size of loan Guarantee covers principle only
Eligibility Criteria	Small and medium sized enterprises, agriculture sector and the plantation sector
Approach	Varies
Terms and conditions	Maximum Loan Size LKR 10 mln.
Process	PFIs are responsible for screening and appraisal.
Pricing	Premium- 1% of amount guaranteed
Claims and Recovery	If loan instalments remains unpaid > 3 months, PFI sends notification to CBSL. PFI claims are reviewed by CBSL only after PFIs initiate legal action against the borrower to recover the loan. Only after settlement of the claim, money recovered is divided equally between CBSL and PFI.

[65] Central Bank of Sri Lanka: Agency Functions

Key Takeaways from a Scheme in Transition

Sri Lanka's various credit guarantee schemes were set up to address the SME A2F constraints in the country but the schemes have been limited in their effectiveness. The various schemes suffer institutional capacity issues, relatively high administrative costs to banks, claims processing delays, poor monitoring by banks, and poor repayment capacity issues with the borrowers.[66] In fact, the poor state of the CBSL's CGSs have prompted donor-initiated efforts to restructure the existing guarantee system. Similar to Nepal, Sri Lanka has no prior experience in setting up separate credit guarantee entities and the country faces similar challenges in navigating various guarantee models. A recent World Bank project proposed a scheme to be operated through the Sri Lanka Insurance Corporation, but no actions have been taken to date.[67] In early 2017, the Asian Development Bank (ADB) prepared a business plan for a new Credit Guarantee Institution in Sri Lanka.[68] The plan includes a demand analysis, financial projections and a presentation of various future guarantee options. ADB is currently providing technical assistance to develop a new national credit guarantee institute for Sri Lanka which will likely entail establishing a legally separate entity with contributions from the private sector (hybrid public/private CGS) that can operate in a sustainable and self-sufficient way.[69] The decision to propose a separate entity (NBFI) was based on the large and complex nature of the guarantee operations required, the general lack of resources on the part of CBSL and the overarching objective to ensure sustainability. Highlights from ADB's recently proposed business plan offer key insights on restructuring and institutionalizing CGSs. [70]

- **Establishment of a separate legal NBFI entity based on a public-private partnership (majority public)** - The model proposed included joint ownership: 80% (GOSL) and 20% (financial institutions). The proposed entity would fall under the supervision of Dept. of NBFI Supervision of the CBSL.
- **Securing buy-in from banks at the outset of the scheme** - Because most FSPs had negative experiences with ongoing CBSL CGSs, it was important to garner bank support early on for establishing an entirely new public-private entity.
- **Offering combined delivery approaches - portfolio and individual** - Combined delivery approaches were recommended with individual loan guarantees encouraged at the outset and a gradual transition to loan portfolio guarantees over the long run.
- **Development of a strong governance structures** - Establishing an independent Board of Directors (appointed by the government of Sri Lanka) including representatives of CBSL, Ministry of Trade and Commerce, private and public banks and others was recommended.
- **Identification of target sectors based on comprehensive demand analysis** - Whereas existing CGSs had focused on agriculture, plantation and animal husbandry, a recent comprehensive demand analysis identified the service sector as major contributor to the economy (50% of overall GDP).

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66 ADB Report (2017); Sri Lanka: Small and Medium Sized Enterprises Line of Credit Project, KPMG.
67 Ibid
68 Ibid
69 Asian Credit Supplementation Institution Confederation Presentation (2017); Credit Supplementation Institutions: Going beyond guaranteed for SMEs.
70 ADB Report (2017); Sri Lanka: Small and Medium Sized Enterprises Line of Credit Project, KPMG.

4.6 Case 6. Tanzania: AGRA's Agro-dealers Guarantee Scheme: A NGO-run CGS play a role in facilitating value chain finance in Africa

Background: Like in most of Africa, the agriculture sector is central to Tanzania's economy and lack of affordable financing to farmers and agro-businesses remains a critical challenge. AGRA, a partnership between the Bill and Melinda Gates Foundation and the Rockefeller Foundation (funded by DFID), has been at the forefront of innovative agricultural value chain finance, utilizing CGSs to facilitate lending by commercial banks to small holder agriculture throughout Africa. AGRA-supported CGSs span the entire value chain from primary food production, post-harvesting, storage, processing, and transportation to trading in inputs and produce.[71]

Description: There are currently 8 CGSs operating in Tanzania (extending approximately $30 mln. in guarantees), four of which are focused exclusively on agriculture.[72] With the exception of one, all schemes are portfolio schemes. Tanzania's Agro-dealer Guarantee Scheme (AGS) is a specialized agro dealer credit guarantee scheme funded by the Alliance for a Green Revolution (AGRA) and Financial Sector Deepening Trust (FSTD). The Trust was set up in 2011 to address specific concern regarding input finance on the part of farmers. AGS provides guarantees for working capital finance offered to agro-dealers who, in turn, provide inputs more efficiently to local farmers. National Microfinance Bank (NMB) was selected as the sole PFI offering a wide network and satisfactory track record working with farmers. AGS was implemented in 12 regions throughout 38 districts in Tanzania. In 3 years, the project issued guarantees to 966 agro-dealers for amount of TZS 13.27 billion.

Like most NGO-driven schemes, AGS focuses on specific target sectors and has a strong underlying development mandate that defines the scheme. Such schemes often involve bundling guarantees with other interventions (e.g. capacity building, value chain advisory services, etc.). In the case of AGS, the guarantor is involved in strengthening borrower's bankability by providing business and financial literacy training to agro-dealers. AGS also incorporates a certification system whereby the Citizens Network for Foreign Affairs (CNFA) offers training and certification for dealers before accessing finance. Lastly, the scheme focuses on building capacity of the lender to improve agri-business lending models.

Design Features	
Guarantee Coverage	50%/50%
Eligibility Criteria	Agro-dealers, certified by CNFA (sufficiently trained in business management)
Approach	Portfolio loan guarantee with NMB
Terms and conditions	Overdraft facilities Only principle of loan is covered.
Process	NMB extends credit to eligible agro-dealers who are required to pledge collateral (at least 62.5% of forced sale value).
Pricing	Varies
Claims and Recovery	No information available

[71] Zander, Miller and Mhlanga (2013); Credit Guarantee Systems for Agriculture and Rural Enterprise Development, FAO.
[72] Dalberg (2011); Assessing Credit Guarantees for SME Finance in Africa: Evidence from Ghana, Kenya, Tanzania, and South Africa, Agence Francaise de Developpment (AFD).

Key Takeaways

Compared to Tanzania's numerous other CGSs, AGS is only a small-scale NGO-funded CGS with a total guarantee fund of only $2.1 million and only one partner FSP. Still, it provides a good example of specialized value chain CGS addressing a specific gap in finance. Similar value chain focused CGSs are increasingly being used throughout much of Africa to facilitate lending by commercial banks to associations of smallholder farmers, agro-dealers and SME agriculture businesses. Highlighted features include:

- **Development of strict eligibility criteria (integrating training and certification) to reduce default rates** - Since AGS's inception, the scheme maintains strict eligibility criteria, incorporating training and certification for agro-dealers prior to issuing guarantees.
- **Delivery of additional support services for agro-dealers** - AGS establishes business clinics and on-the-job counselling for agro-dealers. Loan officers are encouraged to assist businesses with financial literacy and usage of financial services.
- **Decentralization of decision making to speed up approvals** - AGS encourages banks to simplify procedures and decentralize decision making or loan approvals to the branches.

4.7 Case 7. Kyrgyz Republic's Mutual Guarantee Funds: Municipal guarantee funds pave the way for institutionalizing CGSs in the country.

MSMEs are critical to Central Asian economies and access to finance continues to be a constraint to future growth of the sector. Still, only a few Central Asian countries have established credit guarantee schemes despite the daunting A2F constraints these country's face.

Background: CGSs were first established in Kyrgyz Republic in 2011 with the support of USAID's Local Development Program. Currently, there are 6 municipal guarantee funds (MGF) successfully operating in various regions of the country focusing largely on agricultural and non-agricultural processing companies, textiles and tourism. Although these MGFs are relatively new and focus primarily on small projects in the agriculture sector, they offer an interesting example of municipal funded guarantee schemes operating in challenging enabling and institutional environments.

When USAID first considered guarantee schemes, there was no legal framework for regulating credit guarantees.[73] However, local authorities were legally allowed to provide non-profit organizations with resources to encourage economic development in their local areas. For this reason, USAID facilitated the design and implementation of municipal fund guarantees through an independent non-profit organization funded by transfers from municipalities.[74] The capital of the MGFs belong to the municipalities and function as not-for-profit funds. MGF's supervisory board oversees strategic activities and the credit evaluation committee assesses applications after banks have issued loans. All funds proved to be profitable and self-supporting.

Description: Guarantees cover up to 40% of loans extended (but are limited to 10% of the fund capital).[75] Banks provide loans for up to 2-3 years but guarantees are capped at one year. Banks take

[73] In 2016, amendments to the law were adopted by Parliament and approved by President.
[74] Private Sector Development Handbook (2013); *Improving Access to Finance for SMEs in Central Asia through Credit Guarantee Schemes*, OECD.
[75] Ibid.

on 60% of the risk so credit risk assessment and application review is solely the responsibility of the bank. Only after the loan is issued, do banks apply for guarantees. From year 2011 to 2015, 400 guarantees were issued amounting to 35 million and loan repayment remained at 100%.

Design Features	
Guarantee Coverage	• Guarantee of up to 40% of loan amount and up to 10% of fund capital.
Eligibility Criteria	• Focuses on small local projects (due to limited capital); targets difference sectors in the regions of operation • Focuses on agricultural and non-agricultural processing companies, textile and tourism. • Guarantees provided mainly to SMEs in trade sector (62%) but also services, manufacturing and agriculture.
Approach	• Individual (ex-poste) - Evaluation done by bank only and submitted to guarantor after approved.
Terms and conditions	• Maximum amounts of guarantees is no more than 5% of the total fund capital, and no more than 30% of the loan amount • Banks provide loans for 2-3 years; while guarantees are issued for up to 1 year.
Process	• Screening of applications is done by PFI. • Lenders also assist CGS staff in evaluation of creditworthiness (A2FSME- Central Asia)
Pricing	• 1.5% of loan amount to lender • Interest charged to borrowers are set at market rates but are lower than other non-guaranteed credit products
Claims and Recovery	• Not available
Supervision	• Government ministry

Key Takeaways

USAID initiatives launching MGF helped mainstream guarantee funds and institutionalize public CGSs in the country. In 2016, Kyrgyz Republic established a national guarantee fund as a joint stock company with over USD 1 million. (Government) and USD 3 million. (ADB) in capital.[76] USAID also continued to offer portfolio guarantee to 2 Kyrgyz banks focusing on SMEs, farmers and agricultural businesses. Key takeaways include:

- **Ensuring sustainability of MGFs -** Sustainability of the guarantee funds whereby guarantee fees and investment income covered expenses and claims was expected at the outset of the scheme. Fees and commissions were set accordingly.

[76] USAID, Kyrgyz Republic

- **Delegating underwriting responsibilities to banks**. Outsourcing risk assessment and approval responsibilities to banks was considered optimal in order to avoid risk of political interference, ensuring operational efficiency and low default rates.
- **Highly-targeted sector/regional focus of MGFs limited overall outreach** - MGF's initial targeted approach allowed the funds to build the necessary skill base and establish a track record before expanding geographically and broadening its eligibility criteria.

4.8 Case 8. Kazakhstan's DAMU Guarantee Fund: A public credit guarantee fund transitions towards a new independent institution

Kazakhstan's economy is heavily concentrated in hydrocarbon and mining and account for only 30% of the employed population and only 17-18% of GDP. Only one-eighth of total bank loans are allocated to SMEs.[77] For this reason, government and development communities focus on accelerating non-oil economic growth and prioritizing innovative high growth SMEs, particularly in the rural areas.

Background: Kazakhstan's Entrepreneurship Development Fund Joint Stock Company (DAMU) was established by government in 1997 to support a wide range of financial and non-financial support services to SMEs. It was not until 2002, that the fund started its direct lending programs to SMEs. DAMU was initially owned by a sovereign fund (National Sovereign Wealth Fund Samruk Kazyna), falling under the direct supervision of Ministry of Economic Development and Trade (MEDT).[78] As of 2006, 100% of its shares are owned by a government organization called "Baiterek" National Management Holding JSC. DAMU's credit guarantee scheme was established in 2010 as part of the country's Business Road Map 2020 programme, to promote entrepreneurship in key strategic sectors.[79] To date, DAMU is the primary entity supporting A2F for SMEs. It consists of 16 branches and 270 employees and offers SME capacity building services in addition to funding support, interest subsidies and guarantees. There are also smaller CGSs focused on specific sectors like KazAgroGarant.

DAMU FINANCIAL HIGHLIGHTS – 2016

- DAMU achieved more than 50% growth in its performance indicators in year 2016.

- 951 guaranteed projects signed to total amounts of KZT 26.9 billion.

Figure 6: Financial Highlights of DAMU

Description: DAMU functions like a national development institution focused on a broad spectrum of financial support (conditional placement of loans, interest rate subsidization and loan guarantees) and non-financial support (capacity building, training) for SMEs. Its loan guarantee programs are relatively small compared to DAMU's other financial support activities. Its various CGSs cover different market segments but tend to prioritize start-ups and businesses in the specified growth areas (e.g. manufacturing). DAMU also prioritizes youth start-ups and businesses which are modernizing or purchasing equipment to grow their businesses.

[77] World Bank (2015); Project Appraisal Document for a SME Competitiveness Project.
[78] Knowledge Sharing Program: Ministry of Strategy and Finance, Korea Development Institute, Korea Institute for Development Strategy and Korea Credit Guarantee Fund (2012); Credit Guarantee and Credit Evaluation System in Kazakhstan. Report covered KODIT to apply lessons learned for Kazakhstan.
[79] DAMU – official website

Key Features	
Guarantee Coverage	• 50-85% depending on borrower type and loan requested • Up to 85 % on small loans; 50% for larger loans (>$135,000)
Eligibility Criteria	• Start-ups and other established SMEs in priority sectors as defined in the Business Roadmap 2020 program: manufacturing, healthcare, education and tourism. • Priority given to projects that modernize or expand production • No sectoral restrictions for star-ups
Approach	• Individual – A regional council made up of mayors, banks associations, etc. screen applications only after bank approvals have been obtained.
Terms and conditions	• Guarantees up to 10 years[80] • Purpose varies per scheme but covers investments, acquisition of fixed assets, financing of current assets. • Maximum amount as high as 3 billion KZT
Process	• SME applies to bank for loan, following approval, bank submits to DAMU, DAMU makes decision on the guarantee. • Business/Bank/DAMU sign guarantee agreement, and business receives financing. • The process also entails review by Regional Government (Coordinator) in coordination with MEDT (Ministry of Economy and Trade).
Pricing	• No fees for borrowers or lenders
Claims and Recovery	• Information not available
Supervision	• Ultimately controlled by GOK and reports to the Ministry of National Economy

Key Takeaways from a Scheme in Transition

Despite its best intentions to improve access to finance through guarantees, DAMU's CGS activities were lacklustre for some time. In fact, low uptake and low volume of credit guarantees issued prompted efforts to revitalize the guarantee schemes and rethink key design features.[81] Key weaknesses and threats identified in DAMU's recent strategy session reveal the following insights:

- **Sectoral restrictions limiting outreach for CGS** - For a public CGS, DAMU's target markets are narrow and highly focused on strategic priority SMEs (as defined by the Business Roadmap). Despite its best intention to facilitate finance for expansion and new equipment purchases, many SMEs are not necessarily ready to take on investments. Efforts to remove sectoral

[80] Knowledge Sharing Program: Ministry of Strategy and Finance, Korea Development Institute, Korea Institute for Development Strategy and Korea Credit Guarantee Fund (2012); Credit Guarantee and Credit Evaluation System in Kazakhstan. Report covered KODIT to apply lessons learned for Kazakhstan.
[81] DAMU - Development Strategy for 2014-2023

restrictions are underway.[82] DAMU is also planning new guarantee programs that are not limited to industries prioritized in the Roadmap.

- **Operational challenges including overly complex approval procedures** – DAMU's screening process is highly complicated, involving numerous parties in the screening process. Although well intentioned (minimizing SME moral hazard), delays in processing are costly and cumbersome for banks. The involvement of mayors in the decision-making process increased risk of political interference and inefficiencies.
- **DAMU's free charge practice** resulted in financial sustainability challenges. Pricing policy is currently being changed.

Recognizing these shortcomings and the challenges in its other lines of business, DAMU's Board of Directors proposed a development strategy for 2014-2023 to support DAMU's transformation into an effective national institution over the long run. The strategy calls for:

- Increased involvement of the public and private sector in capitalization of the institution
- Improvement of corporate governance and transparency
- Improvement of risk management practices
- Improvement of its internal control systems
- Integration of technology
- Diversification of funding sources, using budgetary funds but also funding from international donors
- Shifting focus to broader SME segments

In 2015 - 2016, DAMU was set to launch a pilot scheme for SMEs independent of the national budget in order to provide access to finance for non-priority sectors (BRM 2020 Program). The pilot program was to be launched with no additional funds for capitalization of the scheme. DAMU plans to introduce more pilot CGSs throughout 2015-2023 as well as develop a credit scoring systems (supported by KODIT). Ultimately, the vision is to establish DAMU as an integrated development institute that can operate in a financially sustainable way and attract external financing. DAMU plans to attract over 252 billion tenge from international finance organizations in the next couple of years. In 2011-2015, it has already raised 134 billion tenge from ADB and the EBRD[83].

[82] DAMU – official website
[83] DAMU Fund to attract over 250B tenge from international finance organizations (May 2016), Kazinform – International News Agency.

5. Section V - Best Practices

Best practices and lessons learned from comparable CGS models can support policymakers in designing and managing successful CGSs. This section provides an overview of best practices and relevant takeaways from the cases reviewed in Section IV. Highlights from the best practices summarized by the World Bank/FIRST initiative (2015) and IFC Policy Guides (2010) were used to inform best practice textboxes below. See Appendix D for a full summary of principles prepared by the World Bank and IFC.[84]

5.1 Eligibility Criteria

CGSs around the world differ with regard to eligibility criteria. In most cases, criteria are based on company size (turnover, # of employees, loan size).[85] Some schemes target businesses operating in certain sectors or businesses in certain parts of the country. Others focus on a category of companies like start-ups, high growth (DAMU, Kazakhstan), or technology-oriented (KIBO, South Korea). Defining eligibility criteria entails consideration of the following trade-offs:

- Non-targeted schemes minimize costs but compromise additionality. Non-targeted schemes typically result in higher uptake and less bureaucratic costs of running funds. But such schemes can be less effective, as tools to achieve specific development objectives. Overly broad eligibility criteria, on the other hand, might encourage applicants that do not actually need guarantees to apply. Portfolio guarantees typically utilize broader eligibility criteria.
- Targeted schemes offer maximum additionality but incur higher costs. Targeted schemes (e.g. DAMU, AGS) are typically focused on alleviating specific financing constraints that satisfy development mandates but incur high operating costs and can put pressure on longer term sustainability. In Pakistan's earlier CGS, for example, overly targeted schemes focused on narrow clusters that resulted in higher costs (less take up, higher verification costs, higher running costs of fund). Also, overly complex eligibility criteria in public schemes can increase the likelihood of political interference.

Best Practices - Eligibility Criteria

- Focus on creditworthy borrowers that have the capacity to repay loans.
- Clearly define eligibility criteria that allow for easy and effective screening.
- Moderate targeting (turnover, # of employees, loan size) is typically encouraged.
- Focus on productive loans as opposed to consumption loans.[86]

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84 International Finance Corporation and Global Partnership for Financial Inclusion (2011); G-20 SME Finance Policy Guide.

85 OECD (2013); SME Entrepreneurship Financing: The Role of Credit Guarantee Schemes and Mutual Guarantee Societies in supporting finance for small and medium sized enterprises, Final Report.

86 Deelen and Molenaar (2004); Guarantee Funds for Small Enterprises - A Manual for Guarantee Fund Managers, International Labor Organization.

5.2 Ownership/Management

CGS are normally established by law, decree or other special legislation. Most CGSs are created, funded and managed as legally independent entities managed by government institutions (e.g. state development bank/state development funds) or managed independently.[87] Ownership structures are often mixed involving both public and private sectors.[88] According to a recent World Bank study in 2016, 80% of CGS's surveyed worldwide were established as independent legal entities.[89] 15% were operated through state-run development finance institutions and less than 1 % by government agency or ministry departments. According to the recent WB survey government was, by far, the dominant owner, followed by state owned institutions, and then commercial financial institutions.[90] Ministries of Finance were most common ownership entities, followed by Ministry of Economy. Central Bank, government agencies and development finance institutions are less common ownership entities.[91] Central Bank ownership varies throughout schemes but majority shareholding is more common (see text box on ownership). Additional text box includes examples of CGSs managed by various government related agencies.

As seen in the cases reviewed, establishing legally separate entity (even if initially implemented through a public institution) allows governments to maintain a degree of ownership and/or control but allows the fund to operate independently thereby improving operational and financial efficiency. This is particularly important in countries with weak institutional environments, where good governance remains a challenge and risk of political interference is high.[92] Also, involving banks early on in the capitalization and ownership of funds (e.g. Malaysia's CGC) offers wide ranging benefits including increased capital and a stronger commercial orientation (good corporate governance, transparency, reduction of moral hazard, etc.). As policymakers in Sri Lanka consider new guarantee models there is consensus on the benefits of increasing non-governmental source of funding to reduce dependency, bureaucracy and government intervention for its future schemes. In Kazakhstan, DAMU also aspires to becoming an independent legal entity with increasing involvement of the private sector in the

EXAMPLES – CENTRAL BANK OWNERSHIP

- Malaysia (CGC) – 78.65 %
- Nigeria Credit Guarantee Scheme - 40%
- Jordan Loan Guarantee Corporation - 49.25%

Figure 7: Examples of CB Ownership

EXAMPLES - PUBLICALLY MANAGED CGS

- Canada Small Business Financing Program (CSBF) managed by government department responsible for economic development

- Chile's FOGAPE managed by Banco Estado (state-owned bank)

- Denmark's Vaekstfonden (growth fund) – a government investment fund providing guarantees, equity funding and subordinate loans to SMEs

- Estonia's KREDEX, a legally independent credit agency, 100% owned by Ministry of Economic Affairs and Communications.

- Slovak Republic's SME guarantee programmes are managed by Slovak Guarantee Development Bank, owned by MOF, public Enterprise Fund and US Small Business Administration Loan Program.

Figure 8: Examples of Publically managed CGS

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87 International Finance Corporation and Global Partnership for Financial Inclusion (2011); G-20 SME Finance Policy Guide.
88 Ibid
89 Callice, P. (2016); Assessing Implementation of the Principles for Public Credit Guarantees - A Global Survey, World Bank. Survey included 60 schemes surveyed in 54 countries.
90 Callice, P. (2016); Assessing Implementation of the Principles for Public Credit Guarantees - A Global Survey, World Bank. Survey included 60 schemes surveyed in 54 countries.
91 Ibid
92 UNESCAP (2017); Small and Medium Enterprises Financing.

capitalization of the institution. By having banks contribute to these future CGSs, these financial institutions will have more of a stake in the development and success of the scheme.

It is also advisable that entities be dedicated to the issuance of credit guarantees and ancillary services such as capacity building technical assistance, training, etc. CGS often require specialized staff with specific skill sets able to perform assessment, approval and monitoring of loans and processing and reviewing claims. For this reason, for example, it is very rare to find CGSs that combine deposit insurance and credit guarantee schemes under one roof. [93]

Best Practices – Ownership/Management

- Establish CGSs as legally separate entities thereby ensuring operational and financial efficiency.
- Encourage private sector involvement (especially financial service providers) is considered highly important to the success of CGSs [94]
- Build in proper statutes that ensure clear separation of roles and responsibilities in order to avoid excessive political interference in the daily operations and management of CGSs (especially important in hybrid models)

5.3 Governance

Successful CGSs require robust corporate governance structures that clarify roles and responsibilities and limit political interference. Especially in public/private hybrid models (with majority public ownership), it is important encouraging the involvement of minority shareholders in the governance of CGS.

Ideally, a CGS should be governed by an independent board of directors that includes representatives from government, private sector and donors. It is crucial that the functions of the board (strategy, policy, etc.) remain separate from that of the management. Political intervention in CGS is still considered one of the major threats to the effectiveness of such schemes and needs to be considered when designing management and governance structures for future. The FAO maintains that political interference has resulted in the failure of many CGSs, specifically those operating in developing countries[95]. The involvement of mayors in decision making process within Kazakhstan's CGSs illustrates the risk of political interference in such schemes.

Best Practices – Governance

- Establish independent board of directors appointed on the basis of clearly defined criteria
- Develop robust governance structures that sets strict boundaries between shareholders (often government), the board and the management
- Establish clear divisions between responsibilities of government control and oversight and the daily operations of the CGS (especially relevant to public and hybrid models)

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[93] Demirguc Kunt et al 2005

[94] OECD (2013); SME Entrepreneurship Financing: The Role of Credit Guarantee Schemes and Mutual Guarantee Societies in supporting finance for small and medium sized enterprises, Final Report.

[95] Study on Credit Guarantee Schemes in Agriculture (2013); FAO.

- Ensure business decisions are free of political interference and influence

5.4 Funding

Effective implementation and viability of CGSs depend on sufficient capital and government support. Initial capitalization of CGSs usually require funding from sources including NGOs, donors, public, and private sources. Set up typically entails some type of start-up help from government and donors and typically entail an initial lump-sum contribution to a guarantee fund. Additional sources of funding could include levies on banks, government subsidies, direct budgetary funding, or equity. The investment of a fixed endowment provides additional income in case incoming fees are insufficient to cover administrative and default costs of guarantee schemes.

In cases where start-up subsidies capitalize CGS, it is considered best practice to ultimately phase out such support and reduce dependency capital injections covering the scheme's operating losses. Designing CGSs that ensure longer term financial sustainability through appropriate pricing, low default rates and low administrative costs is increasingly considered best practice.

Determining the size of funds will entail involvement with banks and borrowers to assess the volume of unsatisfied demand for credit. Initial capitalization of funds is based on size of the target markets and typically ranges between 5 – 10% of total financing needs. Essentially, funds should be large enough to install necessary level confidence that obligations can be met.

EXAMPLES OF FUNDING SOURCES FOR CGS's

- Japanese Credit Guarantee Corporation receives 75% of their funds from local governments and 24% from financial institutions.

- Afghanistan Credit Support Programme – co-funded by DEG (large European DFI) and USAID.

- Kosovo Credit Guarantee Fund capitalized with funding from USAID, German Development Agency KfW and government of Kosovo

- Philippines Credit Surety Fund Program (initiated by Central Bank) was created by a pool of contributions of cooperatives, NGOs, local government unit, and partner institutions such as Development Bank of Philippines, Land Bank of Philippines, Industrial Guarantee and Loan Fund and other parties.

Figure 9: Funding sources for CGS

Best Practices – Funding

- To reduce dependency, establishment of funds from public and private sources including banks, business associations, and private sector) should be encouraged.
- Maximize outreach and additionality in a financially sustainable way.
- Strive for long term financial sustainability by minimizing losses and maintaining equity through adequate funding, sound operational practices, and proper risk management.

5.5 Delivery approach

Selecting delivery approaches for guarantees involves consideration of key trade-offs in outreach, additionality and financial sustainability.

- Individual Guarantees - Individual (retail) guarantees are regarded as more labour intensive entailing separate agencies involved in screening and approving borrowers (e.g. KODIT). Such schemes are often limited in the volumes of applications they can process. On the other hand, individual guarantees imply two sets of eyes (guarantor and PFI) reviewing loan applications, thereby, in theory, ensuring improved loan quality and less risk of moral hazard on the part of

PFIs. Moreover, guarantors might have a better handle on the targeted population it is intending to reach especially for specialized CGSs (e.g. Tanzania's AGS scheme).

- Portfolio Guarantees - Portfolio guarantees delegate screening and approval to the partner financial institutions, thereby reducing the overall cost structure of the CGS. Without the upfront investment in an agency and limited involvement in screening, such schemes tend to be more sustainable over the long run, assuming banks are competent at screening and monitoring the borrowers. This arrangement also encourages banks to develop skills and lending models that encourage MSME lending in the long run. Portfolio guarantees typically have greater outreach as higher volumes of guarantees can be processed. On the other hand, risk of default rates can be higher given only one set of eyes screening and approving borrower applications. Success of such schemes are largely dependent on FSP capacity.

49% of CGS surveyed used in the World Bank survey used individual approach, 41% used a combination of both portfolio and individual and 14% used portfolio approach only.[96] It is not uncommon to use both delivery approaches simultaneously or throughout different phases of the scheme.

Best practices – Delivery Approach

- Evaluate optimal delivery approach by considering trade-offs between outreach, additionality and financial sustainability issues.
- Opt for individual guarantee schemes in start-up pilot CGS schemes, followed by a combination of both portfolio and individual guarantees.
- Opt for portfolio guarantees only if there are sufficient capable and committed partner financial institutions.

5.6 Guarantee Fees

Fees structures of CGSs influence the incentives for both PFIs and borrowers and determine the ultimate sustainability of the scheme. Typically, CGSs apply origination/application fees charged on principal amount (to cover administrative and screening fees) and annual utilization fees on outstanding loan amounts (compensation for risk coverage). Fees vary depending on delivery approach (fees are usually higher for individual due to higher operational costs) and the risk profile of the target segment. In fact, many Asian CGSs use risk based pricing (e.g. Malaysia, KODIT). In most countries, the median annual fee charged by CGSs surveyed by World Bank was approximately 2.4%.

In theory, if fees are set too high, lenders might be reluctant to use the fund. If fees are waived (e.g. DAMU) or too low (CGTMSE's practice of providing lower fees for marginalized borrowers), the CGS risks not being able to cover its operating costs and ultimately jeopardizing longer term financial sustainability.

[96] Callice, P. (2016); Assessing Implementation of the Principles for Public Credit Guarantees - A Global Survey, World Bank. Survey included 60 schemes surveyed in 54 countries.

Best Practices - Guarantee Fees

- Establish pricing that is consistent and transparent.
- Ensure that pricing reflects the risk profiles of the borrower.
- Establish optimal fee structures that consider the sustainability and willingness of borrowers and lenders to participate.
- Charge fees upfront (as opposed to annual) are usually preferable as annual premiums are harder to administer leaving the guarantor exposed to default risk.

5.7 Risk sharing arrangements – Coverage

Coverage ratios should reflect the risk profiles of the eligible borrowers as well the delivery approach (individual vs. portfolio guarantees). In theory, low coverage ratios diminish the purpose of the guarantee and offer little incentive for FSPs to join, thereby limiting the uptake of the scheme. If coverage ratios are set too high, PFIs might be encouraged to take excessive risk compromising the sustainability of the scheme. In general, most coverage falls between 60%-80% and most (70%) cover principal only (as opposed to principal plus interest). [97] Some CGS (DAMU, Sri Lanka, Malaysia, and South Korea) set specific coverage ratios for different programs, products and even credit ratings of borrowers. Guarantees can also be structured as first or final loss. [98]

Best Practices - Coverage

- Avoid 100% coverage and coverage that is less than 40%.
- Ensure guarantees are partial with risks being distributed among the guarantor, borrower and lender. Coverage ratios should ensure that default and claim rates are minimized and sufficient incentives are in place.
- Clarify exact roles and responsibilities for screening applications and monitoring portfolios.

5.8 Default/Claim procedures

Claims management is an essential feature of any CGS and can greatly impact the credibility of a scheme. As demonstrated in a number of the cases (e.g. Sri Lanka, India), inefficient default/claim procedures can influence utilization of a scheme. Ideally, CGSs should have clear and transparent roadmaps covering claims recovery process and conditions for triggering claims.

[97] In 2011 KPMG study of 70 guarantee schemes, 17% covered 50%, 8% covered 100% and the remainder covered 60-80%.
[98] In a first loss guarantee, the guarantor pays an agree % of the amount at time of default with the remaining covered by the lender. A final loss will take into consideration the final amount recovered and divide on the basis of a predetermined ratio between PFI/Guarantor.

Best Practices - Claim Procedures

- Ensure that default and claim procedures are in line with country-specific legal and regulatory framework.
- Ensure claim procedures are efficient and transparent (documented in legal agreements) incorporating appropriate incentives for loan loss recovery. Claims should be settled in a timely manner.
- Ensure that procedures for triggering claims stipulate a maximum period after missed payment for submitting claims
- Avoid conditions that require legal action in advance of submitting claims (e.g. CGTMSE)

5.9 Regulatory and Supervisory Frameworks

Legal and regulatory frameworks for CGSs are typically based on legislation applicable to either a corporation, financial entity or institutions. Supervisory control is usually the responsibility of the Central Bank (e.g. Pakistan CGS) or a central government ministry (e.g. KODIT). Supervising entities should be clearly defined in the chartering legislation with explicit identification of the supervising entity in charge.

CGSs should be subject to proper legal and regulatory supervision covering:

- the adequacy of the corporate governance structure
- compliance with official CGS mandate
- minimal capital adequacy requirements (capital is adequate to pay out potential claims)
- acceptable leverage
- proper risk management practices and procedures
- adequate control and monitoring mechanisms tracking portfolio at risk and providing sufficient loan loss provisions.

The prudential regulatory recognition of guarantees is also critical in calculating risk weightings that can reduce the cost of capital. According to Basel III, the guarantor's credit rating applied to sovereign governments and central banks (with AAA to AA- rating) have 0% risk weight and can be substituted for borrower's rating of the borrower. In the case of CGTMSE, for example, guarantees are treated as sovereign thereby absolving the banks from having to provision. However, compliance with legal requirements (as stipulated by the financial regulator) as well as prudential regulation (covering loan classifications and provisioning rules) are required.[99]

[99] OECD (2013); *SME Entrepreneurship Financing: The Role of Credit Guarantee Schemes and Mutual Guarantee Societies in supporting finance for small and medium sized enterprises, Final Report.*

Best Practices - Regulatory and Supervisory Frameworks

- Ensure that the supervisory role is clearly separated from that of ownership and management of a CGS
- Ensure that supervisory responsibilities are assigned to one entity only - preferably the financial sector supervisor.[100]
- Encourage regular independent audits to monitor the overall effectiveness of the CGS's internal control system

5.10 Capacity Building – other services provided

In addition to facilitating finance, CGSs play a critical role in providing additional support services to both lenders and the borrowers. More than 50% of the CGSs surveyed by World Bank offer additional services including advisory services or training.[101] One-third of the CGSs (concentrated in developing countries) provide capacity building assistance to FSPs. Donor-led portfolio guarantees, in particular, focus on capacity building to improve skills, develop SME lending models and jumpstart innovations in the sector.

Best Practice - Other Services

- Evaluate the capacity building needs of FSPs and borrowers in order to provide necessary support required to facilitate A2F through guarantees. Where possible, utilize donor support to provide necessary technical assistance.

5.11 Performance Measurement

Adequate evaluation mechanisms are required to properly measure performance, especially when accounting for use of public resources. CGS should establish proper monitoring and valuation systems that measure performance regularly. Three main criteria used to measure performance are: (1.) economic additionality (a measurement of improved performance of supported firms through access to finance (2.) financial additionality (a measurement of additional credit creation and improved loan terms and conditions for firms that would otherwise not have obtained credit) and (3.) financial sustainability (a measurement of a fund's ability to cover costs related to operations and loan defaults). Assessing effectiveness of schemes[102]through leverage calculations (amount of guaranteed loans/capital of the guarantee fund) and outreach (guarantee amounts and # of recipients compared to targets) is fairly straightforward. Evaluating financial sustainability is also not a complicated exercise assuming that accurate and timely data is available (see below chart for select indicators measuring financial sustainability). However, measuring additionality (both financial and economic) is far more complex as such measurements often require knowing whether businesses participating in schemes would have been able to borrow in the absence of a guarantee. Given measurement challenges, there are limited impact assessments and comparative evaluations of CGSs to date.[103]

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[100] Callice, P. (2016); *Assessing Implementation of the Principles for Public Credit Guarantees - A Global Survey*, World Bank. Survey included 60 schemes surveyed in 54 countries.
[101] Ibid.
[102] Fund effectiveness indicators can be used to evaluate financial additionality.
[103] Hamilton and Beck (2016, *SME Financing – How to?* Topic Guide, Nathan Associates

Operational Efficiency[104]	
Indicator	Way to measure
Transaction cost per $ of guarantee issued	Operating costs/total amounts of guarantees issued.
Average # of days taken to issue a guarantee (individual guarantees only).	# of days from time borrower presents his request to the fund to the moment that the guarantee is issued.
Average # of days to pay out claims	# of days from the time that the bank sends claim to the guarantor to the time that the claim is settled.
PORTFOLIO QUALITY AND LOSSES INCURRED	
Indicator	Way to measure
Guarantee Portfolio at Risk	Total Amount of guaranteed portfolio overdue/total guarantee portfolio outstanding
Recovery Rate	Proceeds from revenues/pay-outs (calculated for individual lenders). Good ratio is higher than 20%
Net loss rate	Pay-outs (minus recovery proceeds over the year/average outstanding guarantee amount over the year (calculated for lenders separately). Good ratio is below 2%.
Pay-out ratio	Value of pay outs over a year/average outstanding over a year (calculated for each lender separately. Good ratios should be below 3% and not exceed 7% (in fully established fund).

Best Practice - Performance Measurement

- Develop mechanisms to systematically and regularly measure performance on the basis of outreach, financial sustainability and additionality need to be systematically and periodically evaluated (every 3-5 years).

[104] Deelen and Molenaar (2004); *Guarantee Funds for Small Enterprises - A Manual for Guarantee Fund Managers,* International Labor Organization.

6. Conclusion and the Way forward for Nepal

Clearly, the MSME sector in Nepal has limited access to formal working capital and investment credit. SMEs account for approximately 2.7% of total commercial bank lending (representing a mere 1.7% of GDP) [105] and the SME financing gap has been estimated at USD 1.2 billion. If microbusinesses are included, this gap would be significantly bigger. If such businesses are creditworthy but simply unable to access the formal finance channels due to high costs and rigid collateral requirements, there is an obvious imperfection in the market that needs to be addressed. Government initiatives that focus on the symptoms of A2F but fail to address the root causes behind financing gaps will continue to fall short. Without support and proper incentives to overcome market entry barriers, banks will remain focused on business as usual, leaving the MSME sector to rely on their own funds or lend from MFIs and the informal sector.

Based on these findings, the paper builds the case for expanding CGSs as appropriate market friendly interventions that can facilitate access to formal credit and jumpstart innovative and sustainable MSME lending models in Nepal. The paper also underscores the importance of thoughtful design and robust organization and funding structures that enable CGSs to achieve their intended objective. A comparison of international CGSs and best practices revealed the importance of well-designed, well-funded and well-implemented schemes that are based key success criteria including:

- Establishing a separate dedicated independent entities (with clearly distinguishable management and a board) that ensure clear separation between ownership and control and management and daily operations of the scheme.
- Establishing proper legal and regulatory frameworks promoting public-private ownership, independent supervision, proper internal control and risk management and strong corporate governance.
- Diversifying funding base and increased involvement of the private sector in the capitalization and ownership of funds.
- Subjecting CGSs to proper financial reporting requirements and building in regular measurement of performance indicators (additionality, financial sustainability, operational efficiency, etc.)
- Designing appropriate operating features (coverage, delivery approach, pricing, etc.) that address the trade-offs between additionality, outreach and financial sustainability.

Next Steps

Having developed the case for credit guarantee schemes to address the (M)SME financing gap, the next steps will entail establishing the CGS's mission, objectives and target markets amongst key stakeholders and exploring possible institutional delivery models and guarantee designs. A comprehensive demand analysis identifying specific target markets, anticipated credit volumes, and product needs should be part of a comprehensive business plan that outlines various guarantee structures and design features and provides detailed financial projections.

To date, there are two models being explored: The first mode suggests scaling CGSs within the existing DCGF framework. The second option calls for a separate legal entity dedicated solely to credit guarantees with equity participation from banks and the central bank.

[105] NRB/World Bank Publications

Currently, DCGF operates various credit guarantee schemes and has significant experience managing CGSs throughout the country, but credit guarantees are not DCGF's primary business and, to date, only 2 (out of the 28 commercial banks) have entered into credit guarantee arrangements with DCGF. It is also unclear if DCGF has sufficient resource capacity to operate larger and more complex schemes over the long run. Furthermore, given low utilization of existing schemes, it is also questionable how committed FSPs will be to participation in future schemes. Given international experiences and prevailing best practices, an in-depth look at the organization is certainly warranted in order to ascertain DCGF's suitability and/or readiness as an institution to take on larger MSME guarantee schemes in Nepal. Such an assessment might include analysing key performance indicators as well as evaluating design features, credit risk assessment, operational efficiency and management capacity.

The second scenario entails establishing a dedicated independent legal entity (financial/NBFI) focused solely on credit guarantees. Setting up such an entity would allow for the participation of both public and private sector in the capitalization and ownership of the scheme. Engaging financial service providers early on would offer the obvious benefits of a stronger commercial orientation and increased capitalization of the fund. Such a hybrid structure would also allow government to retain control but limit direct involvement in the daily operations of the scheme. Finally, despite the higher start-up costs of establishing a new entity, such a fund - if properly designed and well-funded - would be able to sustain itself over the long run.

The optimal solution is clearly a model that can effectively catalyse commercial financing to MSMEs and contribute to long lasting change in Nepal's banking sector by jumpstarting innovations in SME lending sector and developing new SME lending technologies, risk management practices (screening, cash flow lending, monitoring, etc.) and SME based delivery mechanisms. Such a model should, however, also be part of a broader and more holistic approach to facilitating A2F - one that addresses the supply as well as the demand and enabling environment constraints in the country. Capacity building technical assistance for banks and borrowers will, no doubt, help to improve the effectiveness of future CGSs.

Moving forward, it is our hope that this paper provides stakeholders with key insights and global best practices on launching and scaling CGSs and that, in collaboration with key stakeholders like NRB and the MOF, an active dialogue can be jumpstarted to address critical next steps and the way forward for Nepal.

Appendixes

Appendix A – Pros and Cons of Credit Guarantee Schemes

Pros	Cons
• Stimulate growth and improve allocation of resources (especially true in countries where banks have excess liquidity but no desire to lend). • Improve access to information on borrowers in coordination with registries (especially in weak institutional environments). • Demonstrate to banks the potential profitability of lending to SME markets. If guarantees can reduce market entry risks, banks are more willing to explore new products, reducing aversion to new innovative lending models. • Encourage other banks ("herd effect") to follow the lead of FIs partnering with CGSs resulting in a transformation of the financial sector • Support SMEs during downward economic cycles and soften the impact of credit crunches. (Example: Korea – KODIT) • Leverage large scale lending with less upfront cash outlay (ratio of guarantees outstanding to equity). • Facilitate loans to entities which otherwise would not have been considered as bankable (financial additionality).	• Risk of limited value (additionality) if schemes are poorly designed. • Risk of moral hazard (bank and/or borrowers that abuse the scheme). • Potentially high non-performing loans if target markets include SMEs with limited repayment capacity. • Potentially low demand amongst lenders if there is insufficient liquidity or better returns elsewhere. • Lender reluctance to pay for guarantees (resulting in under-utilization of the CGS) • Failure to have longer-term impact on behaviour • Ineffective in countries where there are high opportunity costs for banks.

Appendix B – Enabling Environment Constraints

Enabling Environment Constraints	
Burdensome regulatory approach for SMEs	The regulatory process for businesses continues to be bureaucratic and has resulted in a culture of non-compliance.[106] 2016 World Bank Doing Business Report ranks Nepal as 105 (out of 189) on ease of starting business[107].
Weak credit information system	Lack of individual credit information bureau for MFIs/Cooperatives (to mitigate the potential of double borrowing) continues to make it difficult for MFIs to lend to potential borrowers (MAP 2016). Credit Bureau covers A, B, and C class Financial institutions for loans larger than NPR 1 million. NRB has also recently mandated D class MFIs to be members of CIB and begin sharing information but due to lack of institutional capacity, most of these MFIs have yet to take advantage of CIB's services.
Collateral registry still gaining traction	A Transaction Registry Office was long delayed because of a lack of regulation, but recently, new legislation paved the way for a moveable asset registry. MoF has recently appointed the CIB to operate the secured transactions registry services. In theory, the registry should record all collateralized assets which will make it easier for banks to evaluate the hierarchy of competing claims on assets.
Strict KYC requirements	Strict Know-Your-Customer (KYC) requirements for deposit taking, remittances, payments and credit extension, discourage MSMEs from entering the financial system and keep them in the informal market. Only low-risk clients (with transactions below a particular amount) are eligible for simplified KYC requirements. MSME typically have transactions that exceed the specified amount and are, therefore, reluctant to bank with formal financial service providers.
Provisioning discriminate against SME without immoveable assets	Loan loss provisioning discriminates against smaller businesses that cannot pledge immovable assets and use personal guarantees. Class A banks in Nepal must provision 20% on loans that are only backed by personal and institutional guarantees discouraging banks from lending to SMEs with no physical collateral.[108]

[106] FinMark Trust, Cenfri and UNCDF (2016); *Making Access Possible Nepal, Detailed Country Report.*

[107] World Bank Doing Business Report (2016) – Nepal.

[108] FinMark Trust, Cenfri and UNCDF (2016); *Making Access Possible Nepal, Detailed Country Report.*

Appendix C – Access to Finance Constraints – Demand and Supply

Demand Side Constraints	
Poor financial literacy and business skills	Many MSMEs indicate their need for credit but lack the skills, or capacity to repay their loans. Often, MSMEs find it easier to apply for non-business loans with cooperatives and MFIs. Also, much of the adult population remains illiterate (26%) which makes access to formal channels more difficult.
Limited access to collateral and information	Despite NRB's permission to disburse loans up to NPR 1.5 mln. without collateral, collateral based lending (biased towards immoveable assets) is still the norm in Nepal. Banks disburse loans up to 80% of the distressed value and require insurance on property used as collateral.
Burdensome Information requirements	Information requirements (financial records, credit history, legal identity documentation and proof of income) are difficult to fulfil. Given the dominance of the informal sector, it is not surprising that many people are reluctant to approach formal channels with burdensome documentation requirements.
Expensive and Inappropriate products offered	Generic products with inflexible repayment periods and high interest rates are often not suitable for MSMEs. For example, overdrafts (lines of credit) are not necessarily appropriate for small businesses (which don't deposit their revenues in the banks). This is especially the case for agro businesses that are seasonable and face irregular income streams.
Proximity	Banking infrastructure in rural areas is weak. Most branches are concentrated in small urban areas with highest density in Kathmandu. According to UNCDF's recent survey, 29% of the adult population have access to a bank within 30 minutes. (MAP 2016). Moneylenders are often much easier to reach. That said, proximity to financial services is improving with the expansion of MFIs and SACCOs. In addition, branchless banking is becoming increasingly popular.
High processing fees	High processing fees (up to 1.5% of the loan value) are a key barrier to uptake for MSMEs.
Lengthy application periods	Often SMEs endure long delays in processing applications.
Limited Awareness	Overall lack of understanding of financial products and services, particularly in the rural areas.
Supply side Constraints	
High transaction costs	High administration costs for small scale lending (per unit cost of extending credit is relatively high). Typically, a high level of involvement on the part of loan officers to interpret scanty financial information, poor accounting practices, and monitoring adds to overall costs.
Lack of information	Many SMEs lack credit histories and often do not comply with reporting requirements. It is difficult for bankers to differentiate between strong and weak businesses so they are quick to charge high rates to cover higher perceived risks.
Lack of collateral	SMEs typically lack collateral due to labour intensity of their operations and low value of machinery and property. Conventional collateral based lending practices instead of projected cash flow based lending. Loan amount typically estimated at 80% of distressed value of loan.

Demand Side Constraints	
Limited Experience with risk - based pricing	Lack of risk based pricing due to interest rate caps.
RIsk of Over-indebtedness in the MSME sector	Potential of over-indebtedness due to borrower seeking credit from multiple banks (with no access to data). Difficulty in accessing data on borrowings and indebtedness is problematic. To date, there is no credit bureau storing data on borrowers from banks that only loan amounts > NPR 1 mln. (MAP, 2016). Check of status with Sakchyam
Poor risk management procedures	There is limited experience with cash flow lending and scoring tools
Informal sector registration challenges	Registration of informal business continue to be problematic.

Appendix D – Principles/Best Practices for Credit guarantee schemes

World Bank/First Initiative - Best practices FOR PUBLIC CREDIT GUARANTEE SCHEMES FOR SMES 109

Legal and regulatory framework

- Establish the CGS as an independent legal entity.
- Provide adequate funding and keep sources transparent.
- Promote mixed ownership and treat minority shareholders fairly.
- Supervise the CGS independently and effectively.

Corporate governance and risk management

- Clearly define the CGS mandate.
- Set a sound corporate governance structure with an independent board of directors.
- Design a sound internal control framework to safeguard the operational integrity.
- Adopt an effective and comprehensive enterprise risk management framework.

Operational framework

- Clearly define eligibility and qualification criteria for SMEs, lenders, and credit instruments.
- Ensure the guarantee delivery approach balances outreach, additionality, and financial sustainability.
- Issue partial guarantees that comply with prudential regulation and provide capital relief to lenders.
- Set a transparent and consistent risk-based pricing policy.
- Design an efficient, clearly documented, and transparent claim management process.

Monitoring and evaluation

- Set rigorous financial reporting requirements and externally audit financial statements
- Publicly disclose non-financial information periodically.
- Systematically evaluate the CGS' performance and publicly disclose the findings.

IFC – Key Features of well-designed Credit Guarantee Schemes

Below is a summary of IFC's key features for well-designed CGSs[110].

Eligibility criteria: Guarantee schemes should target SMEs through reasonable ceilings on turnover, number of employees, and/or size of the loan. However, restrictions on sectors or types of loans should be avoided.

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[109] World Bank/FIRST Initiative (2015); *Principles for Public Credit Guarantee Schemes for SMEs.*
[110] International Finance Corporation and Global Partnership for Financial Inclusion (2011); *G-20 SME Finance Policy Guide.*

Approval rules and procedures: Approval procedures should be streamlined and result in final approval or rejection of the application within a period of two weeks.

Collateral and equity rules: PCG[111] should be allowed to require collateral, although subject to reasonable limits, and should be allowed to require minimum equity for riskier exposures.

Coverage ratios: coverage ratios should ensure sufficient protection against default risk while maintaining strong incentives for effective loan origination and monitoring. Coverage ratios ranging from 50 to 80 percent are common, with ratios typically increasing with the maturity of the loans (lower for working capital loans, higher for investment loans) and decreasing with the age of company (higher for start-ups, lower for more established firms).

Fees: Fees should be risk-based and contribute to the financial sustainability of the scheme.

Payment rules and procedures: Payment rules should take into account the effectiveness of the collateral and insolvency regimes. Schemes in developed countries can base payments on realized losses, but schemes on most emerging countries need to base payments on default events while ensuring incentives for effective debt collection.

Risk management: Strong risk management capacity is key to ensure that guarantees reach targeted borrowers and ensure the financial sustainability of the scheme.

Capacity building: PCG can play a fundamental capacity building role in LDC, for SMEs, and commercial banks. Evaluation mechanism: comprehensive evaluation mechanisms are best practices to measure a PCG scheme's achievements in terms of outreach, additionality, and sustainability.

Supervision: Many PCGs are supervised by central banks in order to ensure the soundness of their operations.

Risk weighting for banks' prudential requirements: A well-designed and financially robust guarantee scheme should allow bank regulators to assign a lower risk weight to exposures that are covered by the guarantee.

[111] PCG – Partial Credit Guarantee Schemes

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