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Assessing Credit Guarantee Schemes for SME Finance in Africa

Evidence from Ghana, Kenya, South Africa and Tanzania

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Executive Summary

To assess credit guarantee schemes (CGSs) in Ghana, Kenya, South Africa and Tanzania, we investigated the entire supply chain running from credit guarantee providers to banks (and other financial institutions) and ultimately to small- and medium-sized enterprises (SMEs). We explored the challenges faced by SMEs in the countries studied, and we examined the degree to which banks are meeting the finance needs of these firms. Drawing on interviews, surveys and focus groups engaging over 100 organizations, we analyzed the landscape of bank financing to SMEs, and more comprehensively, the landscape of credit guarantee schemes that are aiming to catalyze increased bank financing for underserved firms. From these investigations, we developed a framework from which to assess credit-guarantee features and performance, and identified lessons from our findings.

Major challenges faced by SMEs

We chronicled a host of challenges faced by SMEs – described in greater detail in separate individual country reports – but identified three findings that cover some of the most important issues:

- **Financial management capacity is an essential (and often lacking) complement to SME access to finance in the countries studied.** Lack of financial and business management capacity is on its own a constraint to SME success, but can also preclude access to, and effective usage of, finance. Access-to-finance interventions overlook the importance of SME management-capacity building at their peril; and capacity building interventions might be more effective if linked with access to finance.

- **SMEs balk at high interest rates, but this reflects issues on the demand side as well as the supply side.** Interest rates are consistently cited as a top barrier to SME borrowing, as high interest rates mean that only the most profitable SME investments will justify a loan. Banks may overestimate the riskiness of the SME market, but in many cases the pricing of loans by banks appears rational given expected inflation and high historical default rates. The problem of high interest rates is exacerbated when SMEs do not have the skills required to make project finance decisions, including the ability to weigh the potential return on an investment against the cost of capital. Furthermore, SMEs share some of the same conservatism and risk aversion typically associated with banks: because of the historical volatility of the economies in these countries, many SMEs are reluctant to commit to longer-term loans at high interest rates even if the investments themselves appear sound.

- **The stringency of collateral requirements may be the primary barrier to SME ability to access finance.** Even in developed markets, collateral requirements are the rule rather than the exception. Additionally, the level of collateral required is often as high in developed economies as in developing ones. However, SMEs in Africa face unique challenges that include:

- The type of collateral required may be restricted to "landed property" (*i.e.* real estate) rather than accounts receivable or inventories – reflecting either bank conservatism or unfavorable legal environments (or both);
- SME access to collateral is more limited – reflecting lower rates of property ownership and lack of appropriate titling;
- Fewer innovations for unsecured lending are utilized in Africa, even for small transactions – possibly due to a lack of credit bureaus and also general bank conservatism.

Bank financing to SMEs and key limitations

Nearly all banks surveyed in this study concur that the SME market is strategic and important, but they differ in how much they are willing to adapt their traditional approaches to reach the market. Meanwhile, SMEs express that they are not understood or valued by banks. This mismatch in perceptions can often be tied to the types of financing offered by banks – banks may provide basic overdraft facilities but hesitate to offer long-term loans or the types of working capital facilities that SMEs need for growth.

Banks do see the SME market as an important revenue source, but they still remain afraid of the sector because of the difficulty in assessing and managing risk. Banks have begun to lend to the SME market in sizable amounts but, in the words of one leading bank, "have only scratched the surface". Lacking reliable credit scoring systems, functional credit bureaus, and a deep understanding of the businesses of their SME clients, many banks proceed cautiously, relying only on traditional collateral-based approaches. For others, however, a strategy that prioritizes SMEs is yielding new approaches to the market.

Banks have been particularly limited in meeting the working capital needs of SMEs. SMEs cite working capital as one of two areas of greatest unmet need, and most can clearly articulate how lack of working capital has translated into lost opportunities for growth. For example, firms may get a "big break" in the form of a game-changing purchase order, but not be able to fill the order because of a lack of cash. Or they may miss an opportunity to make a large purchase of inputs or equipment at a favorable price. When banks do come through, it is often months too late.

Enterprise Survey data confirm that use of external financing for working capital is very low in the countries studied compared to global averages, and there is a clear difference by firm size. Banks cite a range of reasons why they are uncomfortable providing working capital facilities. In particular, they rarely use inventories and accounts receivable (standard practice in developed financial systems) to secure working capital loans for fear of not being able to collect. Some banks are trying to address this unmet need through innovations in supply chain finance that leverage their relationships with large corporate clients.

Banks are also reluctant to lend at longer maturities, with the possible exception of those in South Africa. Longer-term loans were one of the top two most-cited unmet needs of SMEs in Kenya, Ghana and Tanzania, where median loan durations are 3 years or less. Banks believe that long-term loans are very risky, although this may reflect their concerns about macroeconomic and political risks more than SME risk (median loan maturities are the same across firm sizes). SMEs share some of these fears and sometimes do not want to commit to what they perceive to be high interest rates over a long period of time.

The lack of long-term financing options can contribute to high SME default rates when SMEs attempt to use short-term financing to finance long-term investments and cannot make the payments (thus confirming bank fears of the SME sector and feeding a vicious cycle). It is important to note that banks may not ever be well-suited to meet the long-term capital needs of some firms, which is why venture capital and other complements to bank finance are needed to fill some of the gaps.

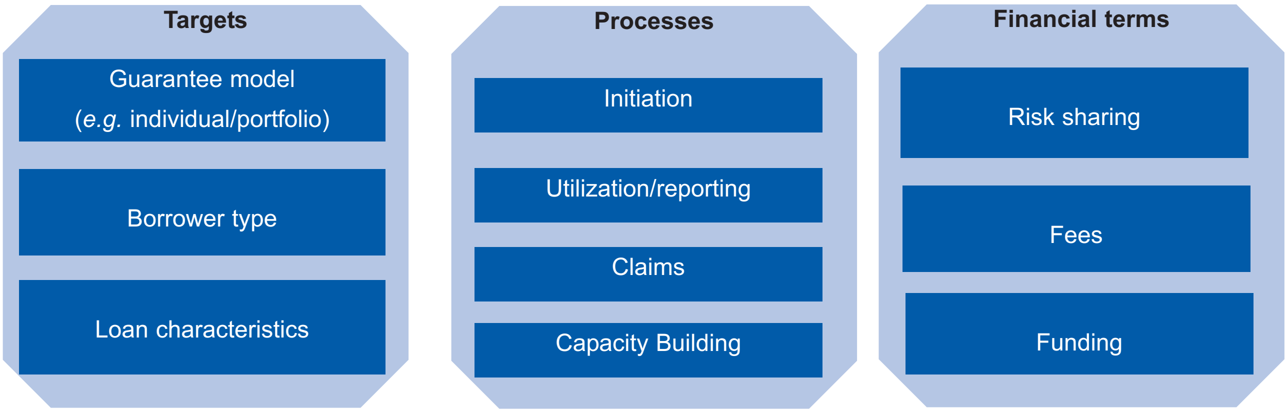
Bank conservatism has traditionally been bolstered by the profitability of lower-risk markets and the lack of competition from other types of financial institutions. Banks in Africa have traditionally made money by lending to the government and large corporates – with relatively minimal effort – relative to the SME market, which requires a new perspective and different mode of operation. In South Africa, consumer credit-card lending also may appear more attractive to banks than SME lending. In addition, except in South Africa, important non-bank financial institutions (like leasing companies and factoring houses) are not competing with banks as they do in developed economies. Sometimes this is the result of tax and regulatory hindrances to the profitability or feasibility of these alternative options. Some SME experts suggest that enabling the development of these alternative financiers will provide for healthy competition that spurs banks into becoming more innovative.

While many banks have not adapted their approaches, in each market there are innovators who are committed to changing the way they operate in order to reach the SME market. Bank approaches to SME lending often depend on the size of the bank and its commitment to reaching the SME market. Large banks that are eager to reach the SME market have the resources to develop sophisticated credit scoring tools or to leverage their relationships with large corporations in order to create supply chain finance products (*i.e.*, where the bank can collect payment directly from the large corporation). Small banks eager to reach the SME market can draw on their flexibility to rapidly develop and improve new types of products to serve SMEs, and often they are "closer to the ground" in terms of listening to the needs of SMEs. In this sense, the larger banks are focused on assessing and managing risk, and the smaller ones are focused on meeting customer demand.

The CGS Landscape in Ghana, Kenya, South Africa and Tanzania

Credit guarantees are one of a range of interventions proposed to address the above issues and improve SME access to finance. Other interventions such as credit bureaus, fostering competition, and addressing legal barriers may address more fundamental issues, but credit guarantees can be a useful tool for accelerating SME lending. The illustration below provides a simple three-dimension framework for assessing the features and performance of guarantee schemes:

Figure 1: Framework for assessing the features and performance of guarantee schemes



Source : Dalberg Analysis

The guarantee landscape in the countries studied is characterized by five major types of providers with different levels of market orientation, sometimes competing with each other to attract the interest of banks. These provider types are as follows:

1. Government-sponsored entity – typically an individual loan program, often not reputed for efficiency, but often engaging the largest number of banks of any guarantee provider;
2. NGO/non-profit organization – likely to have specific borrower/lending targets in line with the organization's mission; may require reporting on social metrics and incorporate TA for borrowers; likely to provide attractive coverage/risk sharing and lower fees;
3. Mutualist/member organization – targets organization members; funding linked to member contributions; may make it difficult to reject loan applications;
4. Donor/bilateral – usually adopts a standard approach across countries, charges relatively lower fees and favors portfolio guarantees with 50-50 risk sharing;
5. DFI/dedicated multi-country fund – may develop customized guarantees with sophisticated linkages to other investments or risk sharing; guarantees should be financially sustainable even while accomplishing a development purpose, which can lead to less attractive terms for banks.

Collectively, these providers have active portfolio guarantees that *target* on average $80 million of guaranteed lending per country. This number is actually quite small in comparison to current SME lending portfolios, estimated in the billions.

Individual loan schemes are already guaranteeing around $30 million, on average, although with some great variation by country: individual programs are guaranteeing at least $42 million in Ghana (excluding a large commodity finance guarantee program); $44 million in South Africa; $30 million in Tanzania; and $2.5 million in Kenya.

Assessing the performance of credit guarantees

The success of guarantees can be assessed first in terms of bank utilization - *i.e.* the amount of bank lending disbursed under the guarantee - and then in changes in market behavior (such as sustained access to credit for the borrowers and increased bank exposure to SMEs). The latter is the ultimate goal, but the former is a critical and often difficult prerequisite.

Bank utilization of guarantees depends on a calculation of profitability that incorporates the full range of costs associated with the guarantee. Extremely forward-thinking banks might factor their future market share into expected returns, but many are likely to look only at the loan returns. The costs banks consider when evaluating a guarantee include:

a. **Financial costs** – High fees can quickly eliminate the profitability of a loan to the lender or attractiveness to the borrower.

b. **Labor/opportunity costs** – Excessive reporting requirements, administrative procedures for utilizing a guarantee, or mentoring/capacity-building burdens can be added to the financial cost of utilization.

c. **Expected value of claim repayment** – Lengthy claims procedures, frivolous hurdles and exclusions, and low levels of coverage reduce the expected value of repayments and hence the attractiveness of the risk-sharing offer.

d. **Expected default rate** – If borrowers perceive a guaranteed loan as a handout, default rates can be higher with the guarantee than they would have been otherwise. This is often exacerbated when CGS providers sell the loans as development aid to beneficiaries. Higher rates of loss coverage (*e.g.* 75-100%) can also increase default rates as the bank staff may not assess the loan applications diligently.

The ability of guarantee schemes to foster long-term changes in SME access to credit will depend on borrower targeting, adjustments in loan procedures, and the transformation of bank perspectives – most likely complemented by capacity development at the bank and/or borrowers.

- For individual guarantees, larger loan sizes are more efficient administratively, but may not reach the most excluded borrowers. For portfolio guarantees, the most effective borrower targeting involves a collaborative effort between the bank and the guarantee provider to find areas of strategic alignment.

- Some guarantees successfully enable banks to reduce collateral requirements or extend loan durations, but others merely provide “comfort” with no changes in loan procedures. It is important to understand how the bank will use the guarantee, because strictly prescribing loan procedures is not always desirable or feasible.

- If a guarantee serves only as an input into an otherwise identical lending and credit assessment process, it is unlikely to have any impact after it expires. Guarantees should be tied to bank initiatives that target specific new markets or product areas. Otherwise, long-term impact will be seen only in the growth of those firms that received guaranteed loans.

- Capacity development is often used as a tool to link the guarantee to concrete operational changes at the bank.

Broader lessons on effective credit guarantees

There are several lessons pertinent to particular contexts and guarantee models for increasing the effectiveness of guarantees. Overall, we developed five broad insights on credit guarantee effectiveness, based on a summary of the guarantee experience in the four countries studied:

1. **Be clear (and realistic) about the desired outcome:** A guarantee will not change the strategic direction of a bank, and it is unlikely to lead to the introduction of new operating procedures on its own merit. Rather, guarantees may:
    - Increase the volumes of existing lending during the lifespan of the guarantee;
    - Accelerate ventures into new markets that the bank is already committed to;

- Test new lending approaches the bank is already interested in.

2. Understand tradeoffs in guarantee design: There is a tradeoff between access to finance and the cost of finance – forcing banks to reduce interest rates to a new customer segment counteracts the incentive to take greater risks. There is also a tradeoff between the market-orientation of guarantees and bank experimentation. Purely market-priced guarantees may help banks "do more of the same" with their SME lending, but concessions may be needed to encourage entry into new and uncertain markets.

3. Select the right partners: Bank commitment to utilizing the guarantee must stem from a strategic alignment of interests that leads to engagement at all levels of the organization. When banks are not strategically aligned with the guarantee objectives, guarantees would be more effective if provided to investment funds and non-bank financial institutions.

4. Do not underestimate the importance of working capital: There is explicit and implicit demand from banks and SMEs for guarantees that enable banks to experiment with new types of working capital financing, enabled through non-traditional securitization (*e.g.* invoice discounting, supply chain finance).

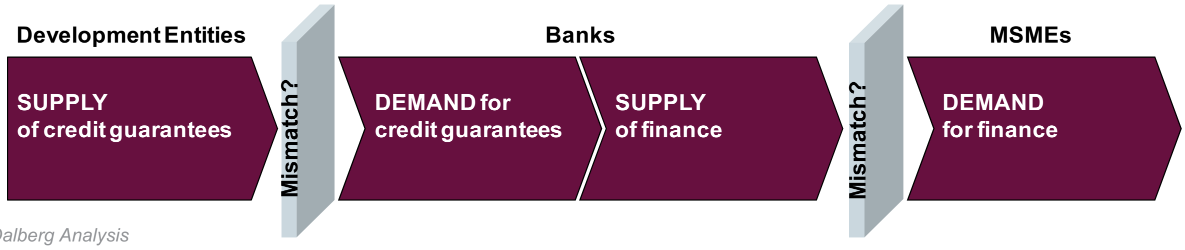
5. Consider the complementary role of capacity building: Banks believe that the development of SME management and finance capacity is critical to the success of guarantees and overall increased SME lending. Banks also require their own capacity building in order to efficiently and effectively utilize guarantees and/or to develop new SME products.

Introduction (Context and Motivation)

There has been considerable attention given to the economic importance of SMEs and the gap in finance that lies between microfinance and corporate finance. For decades, credit guarantee schemes (CGSs) have been a popular tool for addressing this gap, and are believed to be a more effective form of public support for SME lending than directed credit or interest rate/regulatory subsidies (Beck *et al.*, 2008). A number of studies have looked at the nature and effectiveness of credit guarantee schemes, but Sub-Saharan Africa has not featured prominently in these studies, perhaps because it is a relatively newer market for CGSs (Beck *et al.*; Levitsky, 1997). One of the most comprehensive studies of such guarantees (Beck *et al.*, 2008) covers 76 partial credit guarantee schemes in 46 countries, but does not include even one from Sub-Saharan Africa.

Our study attempts to fill some of the gaps in the ground-level knowledge of SME-focused credit guarantees in Ghana, Kenya, South Africa and Tanzania. To date, most of the CGS studies in these countries have been evaluations of specific programs from a single CGS provider (*e.g.* USAID in Ghana and Tanzania, and DFID in Kenya). In contrast, we assess the full landscape of CGS offerings in each country. In addition, we attempt to look more comprehensively at the supply chain that begins with credit guarantees and ends with SME borrowing. This entails presenting the different perspectives of SMEs, banks and CGS providers in order to draw a more complete picture of the design, implementation, and effectiveness of CGSs.

Figure 2: Our study addresses the full CGS supply chain, looking at possible market mismatches



Source : Dalberg Analysis

The purpose of this study is to contribute directly to the efforts of practitioners so that they can more effectively leverage SME financing, through better-functioning credit guarantee schemes, where appropriate. Our primary audience includes development and public organizations engaged in supporting SME access to finance, as well as banks and SME representatives looking to understand the nature of such efforts and the implications for their business.

The findings in this study are drawn primarily from extensive interviews, focus groups and surveys of relevant stakeholders in the four countries, and available documentation on specific credit guarantee schemes and bank operations. We also drew from existing literature on the topics being studied, as well as past Dalberg research on SME banking and SME capacity building in Sub-Saharan Africa. We conducted field visits in the four countries and collected data and perspectives from SME owners, business membership organizations, credit guarantee providers, SME/development experts, and most importantly banks.

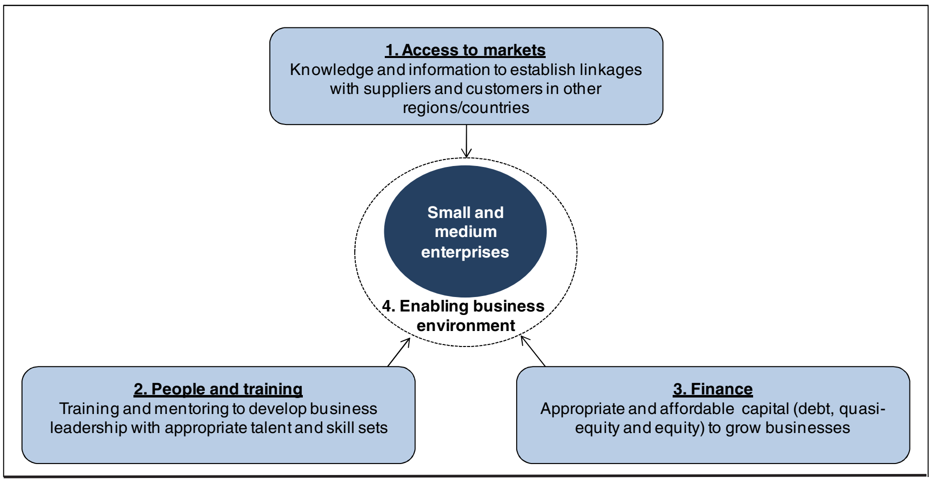
We endeavored to gather on-the-ground perspectives and nuanced insights from the countries studied that may not be available in the existing literature. This report includes a synthesis of these insights as well as selected case studies describing specific CGS experiences and lessons learned. We also constructed a comprehensive CGS database for the four countries studied and an additional compilation of data and analysis on each of the banks interviewed. While these datasets are not appended to this document, the graphs and tables characterizing the CGS and banking landscapes are drawn from this raw data. The construction of the datasets enabled objective comparison and analysis of the range of approaches employed by guarantee providers and banks. Additional information on our study methodology can be found at the end of this report, in Appendix I.

1. Major Challenges to SME Growth and Access to Finance

Most credit guarantee schemes targeting SMEs assume that a thriving SME sector is a critical element needed for a strong and growing economy, and that access to finance is a major constraint to SME growth. While we will not revisit the evidence in favor of the first assumption, below we discuss the barriers to SME growth in the countries studied and where access to finance ranks among these barriers. (We emphasize bank financing because that is the tool that CGSs primarily hope to leverage to meet SME needs.) Among a range of challenges, we look most closely at the overarching issues of (financial) management capacity, high interest rates, and stringent collateral requirements. Later, in Section 2, we dig deeper into the supply of bank financing and related issues regarding unmet SME demand for financing.

The challenges faced by SMEs have been elaborated exhaustively in numerous studies, and we will not endeavor to catalogue them again here. The framework below, developed from previous Dalberg research and analysis, summarizes the needs of small and growing businesses (*i.e.* the SMEs that may have the most potential for economic impact but are also the most likely to have difficulty gaining access to finance) in terms of four major needs: access to markets; people and training; finance; and an enabling business environment. The challenges faced by SMEs can usually be linked to a breakdown or barrier in one of these four areas, and SME interventions typically target one or more of these types of barriers.

Figure 3: An SME-needs framework



Source : Dalberg Analysis

This SME-needs framework helped guide the identification of country-specific barriers to SME finance that underpinned our assessment of credit guarantees in each of the countries studied. Our discussion below of SME-management capacity, interest rates, and stringent collateral requirements is a synthesis of that research and also touches on these four SME needs.

1.1. Management capacity (especially financial)

Surveys such as the *World Bank/IFC: Enterprise Surveys* now regularly ask firms around the world to identify the major constraints to growth; access to finance consistently ranks near the top for small firms in developing countries. Other issues receive attention depending on the country, but access to finance seems to be one of the most universal obstacles. However, these surveys do not ask firms whether limited management capacity is an obstacle, perhaps because the survey respondents are managers themselves. It is hard to quantify – and harder to address – gaps in management capacity, but these gaps may constitute an even more universal and more restrictive barrier to SME growth than access to finance. This at least reflects the perspective of banks, SME experts, and SME investors active in Sub-Saharan Africa.

Table 1: Top 3 obstacles cited by small firms: "limited management capacity" does not appear because it was not ever presented as an option

	Ghana	Kenya	South Africa	Tanzania
Small firms % citing barrier as	Electricity (45.9%)	Tax Rates (24.4%)	Crime, Theft and Disorder (40.3%)	Electricity (69.9%)
"the biggest obstacle faced"	Access to Finance (39.6%)	Access to Finance (18.3%)	Electricity (18.0%) (11.9%)	Access to Finance
	Tax rates (4.8%)	Practices Informal Sector (12.6%)	Access to FInance (8.5%)	Transportation (3.9%)

Source : World Bank/iFC Entreprise Survey Data 2005-2009

Lack of management capacity, especially financial management, is a constraint to SME growth because many SMEs do not effectively budget, compare market opportunities, assess investment options or manage cash flow. Regardless of whether they can obtain loans, SMEs are likely to fail if (as is often the case) they do not have reliable information on the profitability of their operations, or if they are continually diverting funds and effort into initiatives that have no strategic value to their core business.[1]

On top of the intrinsic constraints to growth arising from these management issues, lack of financial management capacity is also an obstacle to accessing finance. It is difficult to convince a bank to lend you money if you are not able to provide reliable information on your current or projected operations. SMEs have become so known for poor financial management and reporting that a number of banks interviewed used these characteristics to form the bank's definition of an SME. In other words, if a firm was small but could provide accurate financial information and demonstrate good corporate governance, it would be classified as a corporate client.

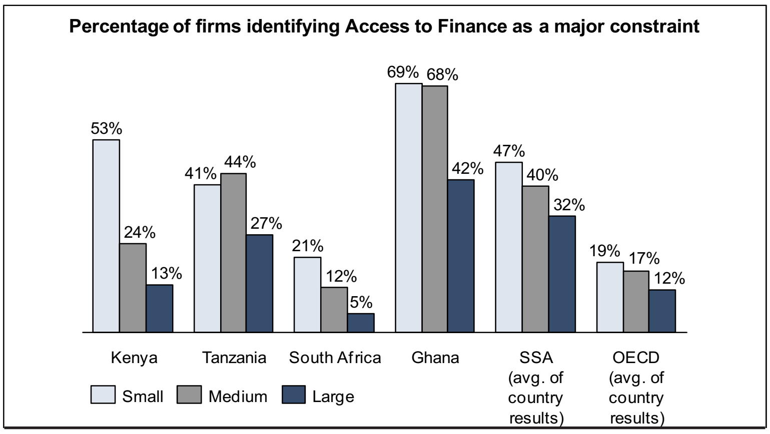
It is important to consider SME management capacity because any access-to-finance intervention will be limited in its impact if the targeted SMEs are not somehow improving management of their finances, strategy and operations. This view is shared by SMEs and banks alike, but the question of how to facilitate this improvement has not been clearly answered. Our research suggests that building SME management capacity and improving access to finance are complementary goals, and that each may be better achieved in coordination with the other.[2]

[1] Traits of SMEs both observed directly in prior analysis and highlighted by interviewees.
[2] This includes our previous research on SME capacity building programs throughout Africa, also cited later.

1.2. Access to finance: High interest rates

Having acknowledged the importance of SME management capacity, there is no denying that access to finance is itself a critical issue, especially in Ghana, Kenya and Tanzania, and one that affects smaller firms disproportionately. The figure below shows *Enterprise Survey* data for firms identifying access to finance as a "major" constraint (though not necessarily the "biggest"). Results for the four countries studied are compared with the average responses for OECD countries as well as the average for countries in Sub-Saharan Africa. With the exception of South Africa, large percentages of firms in the study countries are constrained by a lack of access to finance. And in all four countries, there is a significant difference among small, medium-sized and large firms. In OECD countries, fewer firms are constrained by lack of access to finance, and the gap between large and small firms is smaller.

Figure 4: Small and medium-sized firms in the countries studied are much more likely to have problems with access to finance than larger firms



Source : 2005 - 2009 World Bank Group Entreprise Surveys.
Uses latest data available for 15 OECD countries and 37 Sub-Saharan African countries

Access to finance is deeply linked with interest rates in the minds of many firms. In fact, the previous wording of the *Enterprise Survey* used "cost of finance" in place of "access to finance". Interest rates were the second most-cited reason for limited SME borrowing by the 30-plus SMEs we surveyed in Ghana, Kenya and Tanzania. (See graph in subsection 1.3). However, this points to issues on the demand side as much as on the supply side.

Effective interest rates, when combined with fees, are indeed high in Africa by many standards. In Kenya they reached 18% at the time of our research, while in Ghana banks have been accused of making exorbitant profits by charging 25%-35% even after the central bank rate was reduced to 13.5%.[3] However, these rates can usually be rationalized by inflation, transaction costs, and especially default rates. In Ghana, non-performing loans reached 18.7% of total lending in 2010, a recent phenomenon that has been widely blamed on extensive government arrears that have impacted firms contracting with the government.[4]

Having to pay higher loan costs to cover the default of other firms is certainly a serious obstacle for SMEs, but the reason why high rates can be prohibitive often has much to do with the capacity and attitudes of the SME itself. Firstly, SMEs do not always have the skills required to make project finance decisions, as this requires an in-depth understanding of the cost of capital compared with the

3 Interviews, and press reports: http://www.ghanaweb.com/GhanaHomePage/NewsArchive/artikel.php?ID=187660.
4 *Ibid*; also interviews.

potential return on investment; so they may choose not to invest even in projects with a high payoff. Secondly, it is not just banks that are risk averse in these markets, but SMEs are also afraid of uncertainty. SMEs fear making long-term investments at high interest rates because the longer the time period the more likely it is that some catastrophe will lead to lost revenues, and they will not be able to repay. In Kenya, SMEs often refer to the post-election violence of 2007/08 and the fact that the next round of elections is now only a year away.

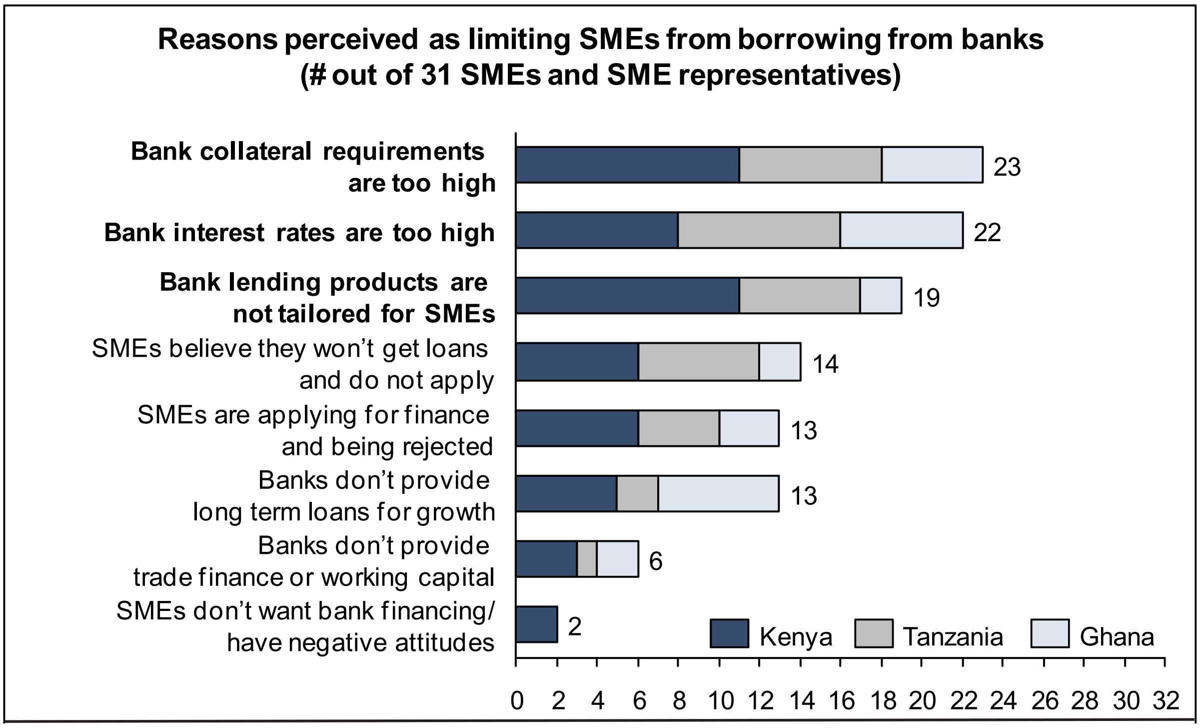
Some SMEs seek lower interest rates as a buffer against negative shocks, even if their project would otherwise just-ify the higher rates. But there is also evidence from all the countries studied that a significant number of SMEs would be willing to pay higher interest rates if it would make it easier for them to be approved for a loan.

1.3. Access to finance: Stringent collateral requirements

The most commonly cited limitation to SME borrowing among the SMEs we surveyed in Ghana, Kenya and Tanzania was that bank collateral requirements are too high (see Figure 4 below).[5] In South Africa, collateral requirements appear to be a concern primarily for the smallest firms. At first glance, average collateral levels in the four countries studied seem quite high: ranging from 106%-120% for small firms, and 101%-130% for medium-sized firms. However, note that collateral requirements in Germany are 124% for small firms and 130% for medium-sized firms, yet access to finance is not considered a major barrier to SMEs there. It is not the level of collateral required that appears to be the problem for the African countries, but the inflexibility of capital requirements and difficulty in obtaining collateral that particularly affect SMEs. Borrowers in Ghana, Kenya and Tanzania are required by many banks to use only landed property as collateral. Slightly less-conservative banks may allow use of the asset to be financed as collateral, especially if it is a registered vehicle. Only the most progressive banks appear willing to venture deeply into debenture, use of inventories, or accounts receivable – which are all standard means of obtaining financing in OECD countries. The reasons for this are often linked to the legal system in the country, where the enforcement of contracts may be very difficult and only registered assets (property or vehicles) are useful in securing a judgment against a debtor. There are also few if any collections agencies and markets for repossessed goods. And one bank noted a general “lack of trust in the market”, which is necessary for collecting on accounts receivable, and is often taken for granted in the developed world.

[5] Because data on the SME sector and its access to finance are especially limited in Ghana, Kenya and Tanzania, we conducted focus groups and distributed a small quantity of SME surveys in these countries to supplement our other research, and provide a sanity test of the qualitative insights derived in interviews. We did not distribute these surveys in South Africa, where a series of more-representative studies of SME access to finance were already available. This enabled us to focus more on understanding the perspective of banks and CGS providers, but one drawback is that the types of data available in the SA studies do not match up one-to-one with our surveys. Thus South Africa data is not included in graphs of our SME survey results, including Figure 4.

Figure 5: Collateral requirements, interest rates, and poor product design are chief limitations to SME borrowing from banks



Source : Dalberg interviews in Kenya, Tanzania and Ghana

Another reason why collateral levels in line with those in the OECD are a significant barrier in Africa is lower rates of property ownership among SME owners. SMEs in Sub-Saharan Africa are owned by poorer people than in the OECD, and on top of that, owners who do have land may not be able to obtain a proper title for it. This is especially true in Tanzania, where private property is a relatively recent phenomenon. People may have squatter cards but land titles are very rare. As a result, some banks do lend on informal deeds (*i.e.* a letter signed by neighbors to the North, South, East and West), but there are challenges when a bank tries to sell a foreclosed property and no one wants to buy their neighbor's land.

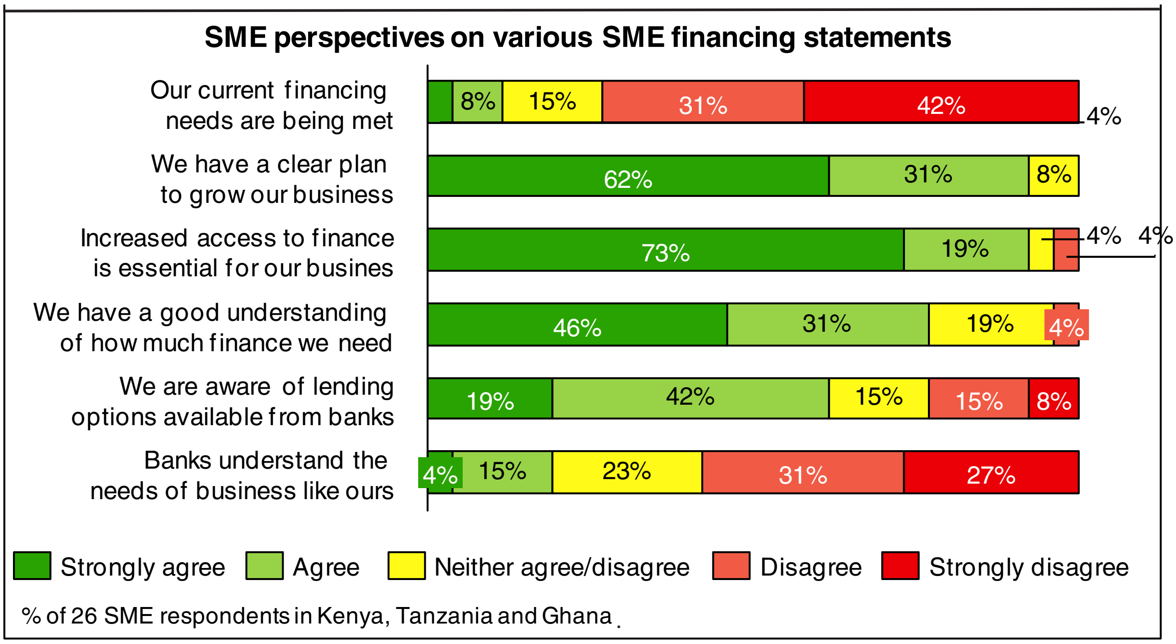
Lastly, SME borrowers face stringent collateral requirements because there is a lack of tools and innovations that enable unsecured lending and improved risk management, such as national credit bureaus. Ghana and Kenya have only recently established such bureaus (which enable lending based on credit history), and they are still being populated with data. In Kenya, the establishment of credit bureaus appears to have been led by the private sector, with the support of banks and recognition by the Central Bank of Kenya of the first credit bureau in early 2010. In Ghana, the first bureau was established in 2009, but banks have reportedly been less cooperative in sharing information, and the government has had to use regulation to force banks to share the data necessary for the system to succeed. Tanzania is further behind – it is in the process of developing a credit bureau, as well as a national ID card system. These types of developments have been delayed in part because banks in Africa have historically not been eager to solve such information problems in order to reach the SME market.

The collateral situation is more favorable for SMEs in South Africa, where credit bureaus are well-established, property ownership is more prevalent, and lenders generally accept a larger range of collateral types. However, there are still structural challenges that hinder the use of some important alternative forms of collateral by banks (FinMarkTrust, 2009). These alternative forms are particularly needed in the financing of "*start-ups, micro-enterprises, entrepreneurs from previously disadvantaged communities, or any other group with limited collateral or weak (or limited) credit histories*" (*Ibid.*). For example, unlike in much of the rest of Africa, factoring and invoice discounting are widely available for "the better established small and medium business sector" in South Africa. But there is a ban on cessions of accounts receivable for government contracts, which means that such financing is not available for government suppliers, which are typically very small firms. Another hindrance is that movable assets to be used as collateral must be transferred to lenders up front, unless a notarial bond is registered through a process that is complicated and costly, especially for smaller firms (*Ibid.*).

2. Bank Financing to SMEs and Unmet SME Demand

Consistent with the national surveys in Ghana, Kenya and Tanzania, a majority of the SMEs we interviewed in these countries indicated that their financing needs are not being met. Additionally, the perception among most of these SMEs was that banks do not have a good understanding of SMEs (see figure below). These perceptions do not appear to be as strong in South Africa,[6] even though banks in that country are still perceived by a range of stakeholders as being very conservative in their behavior.

Figure 6: Most SMEs surveyed believe that banks do not understand and are not meeting their financing needs



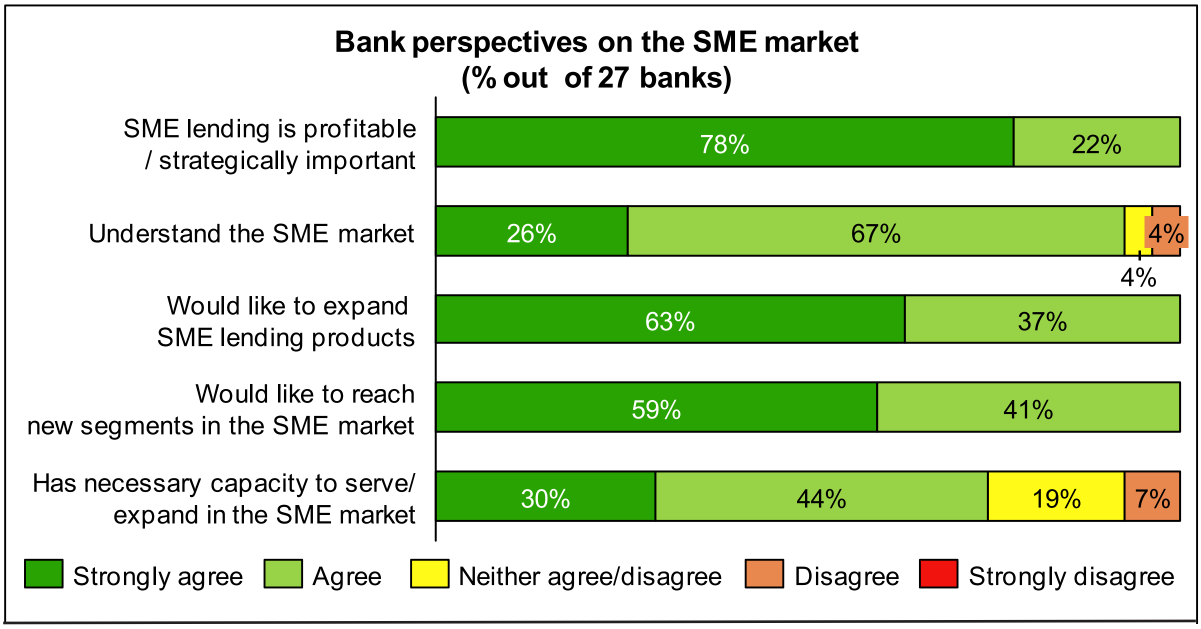
Note: While we did not collect parallel data in South Africa from SMEs, we found (from interviews and previous studies) that firms appear relatively less concerned about difficulties accessing bank finance, though their awareness of lending options may still be limited. The major banks are still perceived as being conservative in their behavior despite being more advanced in their ability to measure creditworthiness.

Source : Dalberg Analysis

But even as SMEs complain that banks do not understand their needs, banks across the four countries consider SMEs as a highly strategic sector to which they would like to expand their lending. All the interviewed banks expressed a clear commitment to lending to SMEs. This is in line with global trends indicating that banks are beginning to view SMEs as a profitable segment. For example, a recent survey of 91 banks in 45 developed and developing countries found that over 80% of these banks perceived the SME sector to be a large market with good prospects (Beck *et al.*, 2008).

[6] South Africa has a vastly more sophisticated financial system, as indicated by the fact that domestic credit to the private sector is 150% there, compared with 30% in Kenya, and 15% in Tanzania and Ghana. (See graph in Appendix II.)

Figure 7: Banks generally consider SMEs highly profitable and would like to expand their lending in the sector, although not all are confident in their capacity to do so



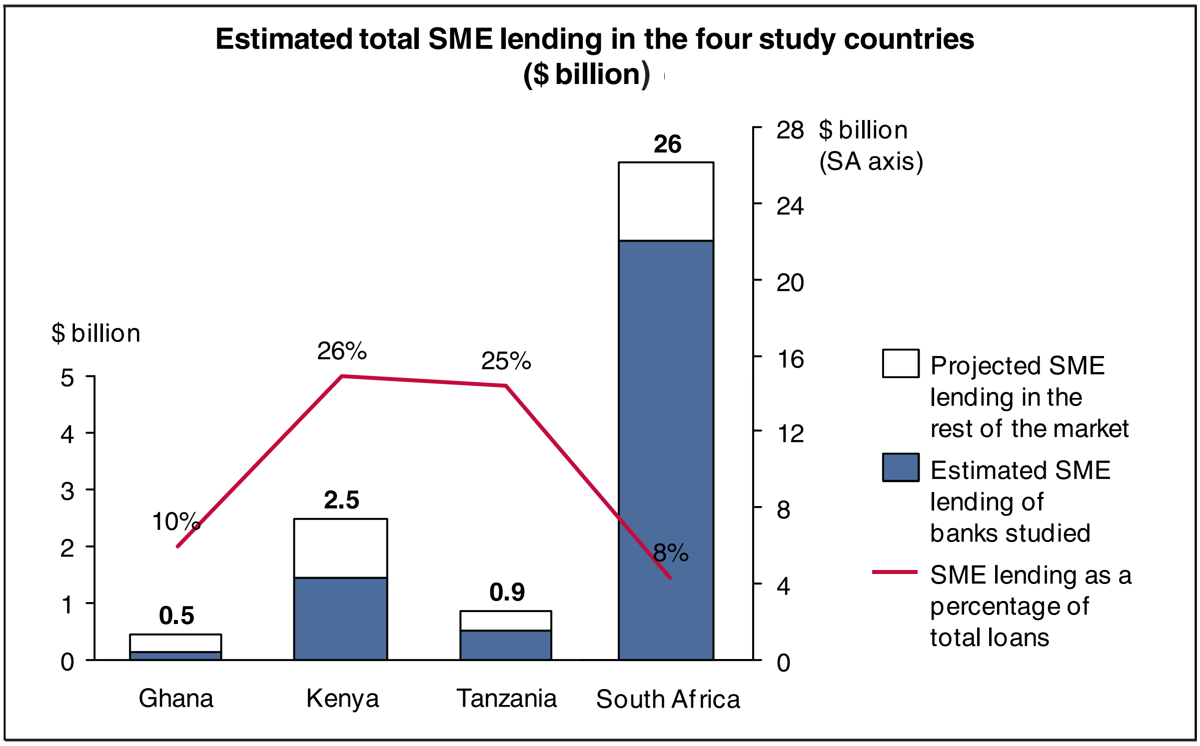
Source : Bank survey results in Ghana, Kenya, South Africa and Tanzania.

Banks in all four countries say they consider the SME market to be an important source of revenue, with a market size compelling enough for them to expand their lending to this sector. Some of the banks we interviewed in Kenya and Tanzania have made a strategic decision to shift to SME lending as their core business, due to increased competition for corporate clients and the realization that SMEs constitute a huge untapped market. As a result, bank SME-lending portfolios are reaching sizable volumes.

Figure 7 below estimates the total SME lending portfolios in Ghana, Kenya and Tanzania based on data provided in interviews and information on bank market share. Note that the current SME lending portfolios dwarf the amount of SME guarantees active in these countries. In Kenya, for example, guarantees currently target $72 million in SME lending, equivalent to just 3% of the estimated $2.5 billion lending portfolio.

Note also that the relatively low volume of estimated SME lending in Ghana is likely linked to the very narrow definition of SMEs that many Ghanaian banks use to define the sector (*e.g.* less than $1 million or $2 milllions in turnover, or as another bank defines SMEs: "*owner managed businesses with no Board that mostly do small sized transactions and require only basic products*"). It is likely that many bank clients currently classified as "corporate" by banks in Ghana would qualify as SMEs based on the SME definitions used in other countries.

Figure 8: Banks in Ghana, Kenya and Tanzania are lending a combined ~$4 billion to SMEs, and ~$26 billion in South Africa



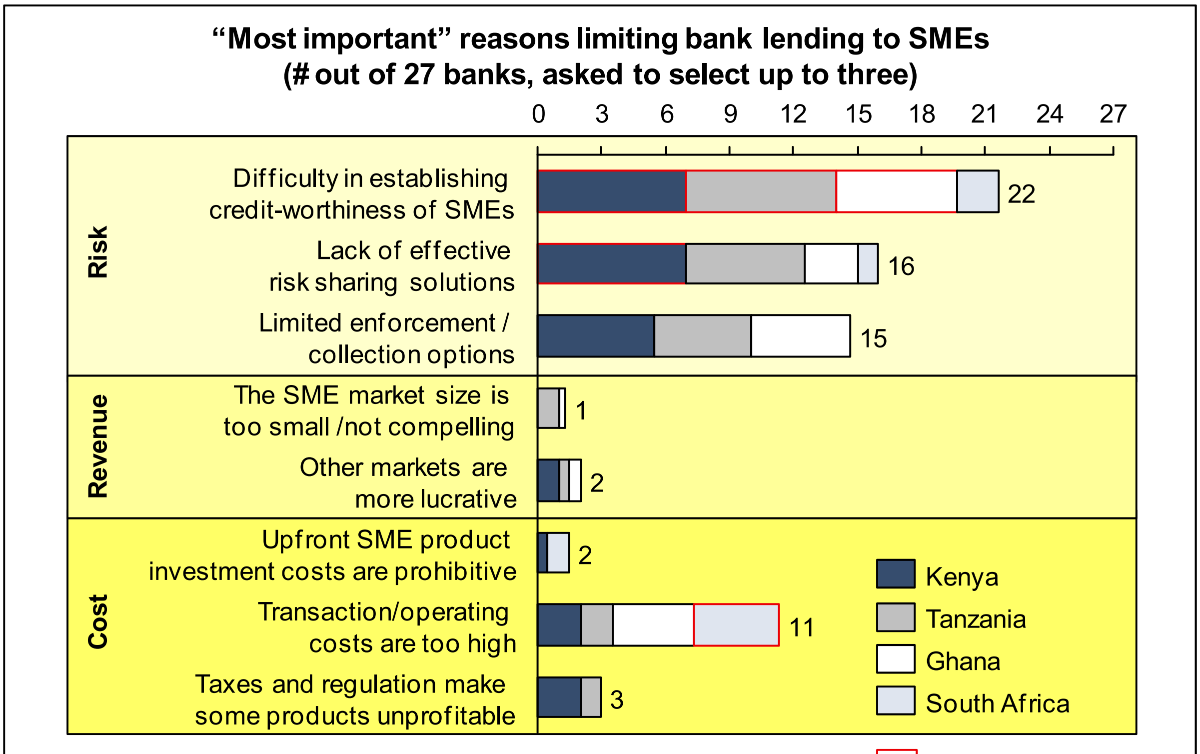
Source : In interviews, banks provided % of portfolio devoted to SMEs; total portfolio data available in bank annual reports and banking supervision reports (2009 data); Note : we assume that the aggregate ratio of SME lending to total portfolio lending is the same for the remaining banks (not interviewed) as it is for the banks providing us data; this assumption is not as critical where we have data for most of the market; in South Africa, we filled gaps in bank-reported date on % SME lending by using ratios from a historical (2001) estimate in an internal central bank report.

Despite the lending already flowing into the SME sector, the head of credit at one of the largest SME lenders in Kenya explains that, *"we have only scratched the surface of the SME market*". One reason for the gap between bank intentions and SME demand for finance is the continued difficulty banks have in measuring and mitigating risks. (High transaction costs associated with SME lending also limit SME lending by some banks.) The difficulties in measuring risk relate to a lack of reliable financial information from SMEs, and the lack of borrower history. Only in South Africa is there a fully functioning credit bureau system. In the other three countries, credit bureaus are in different stages of development and implementation.

> *"A credit referencing bureau is critical in this market – At the moment loan defaulters in Tanzania are having a field day."*
>
> – Managing director, Tanzanian Bank

On the side of risk mitigation, banks cite a lack of effective risk-sharing solutions and weak legal environments that make it difficult to collect on defaulted loans. Figure 8 below shows how banks in the countries studied ranked the various barriers to SME lending. This analysis is selected from a larger body of country-level research that we conducted on the range of challenges faced by banks in SME lending and on unmet SME demand.

Figure 9: Risk-related reasons dominate the list of barriers to bank financing of SMEs



Source: Stakeholder survey results in Kenya, Tanzania, South Africa and Ghana (Fractions result from weighting multiple survey responses for the same bank).

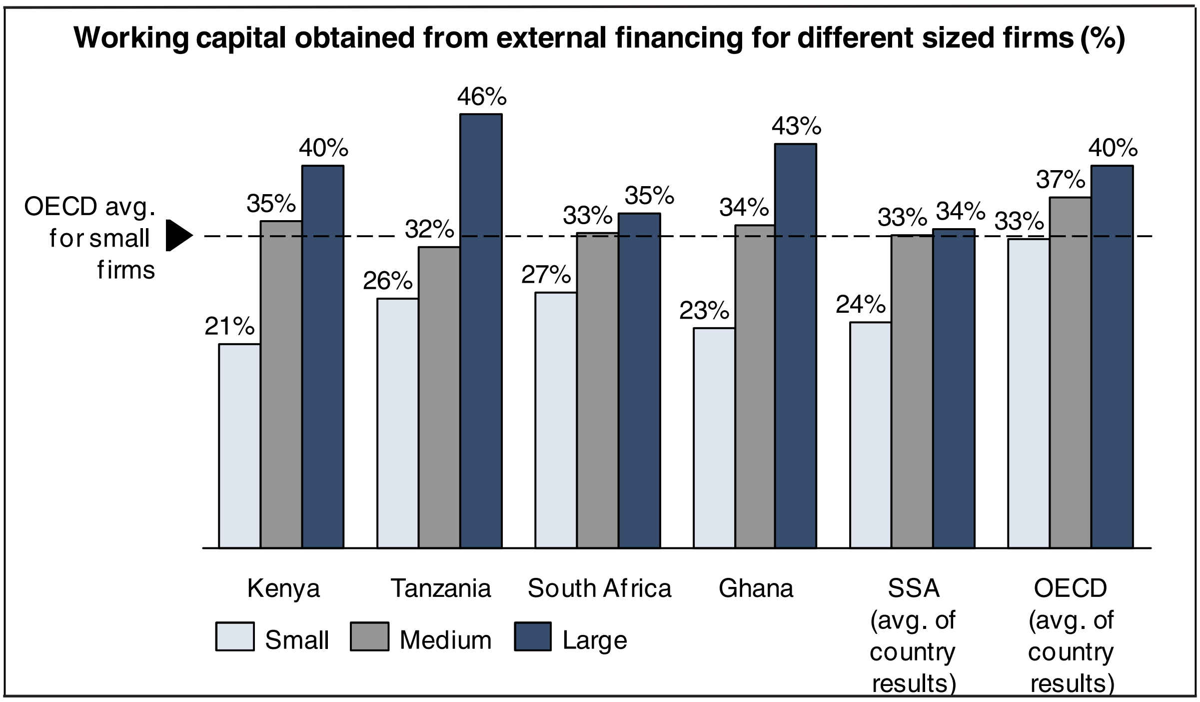
The reason for the mismatch between SME demand and bank supply goes beyond simple issues of risk management – the underlying message one hears from SMEs across the continent is that banks do not understand their businesses and do not make sufficient effort to provide financing that meets their needs. This complaint is usually strongest when it comes to banks' inability to meet SME working capital needs.

2.1. Limited provision of working capital

SMEs interviewed often reported that there are significant gaps between the form of finance they had access to (typically overdrafts) and what they really need. SMEs cite working capital as one of the two areas of greatest need that is unmet by banks. Working capital, which enables SMEs to expand their operations incrementally and meet ongoing operational expenses, is directly linked to the growth and survival of SMEs. The lack of appropriate working capital products has resulted in SMEs relying on traditional loans, which typically entail lengthy approval procedures. Several SMEs spoke of instances in which they were unable to meet customer orders, or make an important purchase, due to delayed loan approvals. The speed of approval for working capital is critical as SMEs may have only a limited amount of time to fulfill a particular order – some SMEs mentioned using mostly overdrafts because when a good opportunity comes their way they cannot afford to wait out the lengthy loan procedures.

The figure below shows *Enterprise Survey* data confirming that the use of external financing for working capital is low for SMEs in the countries studied, as compared to the developed country (OECD) average. What is more striking is that the gap between large and small firms is much wider for the countries we studied. Ghana, Kenya and Tanzania average a 20 percentage-point difference between large and small firms, whereas that difference is only 7 points for the OECD countries, and 10 points for Sub-Saharan Africa. While overall rates of external working capital finance might not completely reflect the supply of working capital (*e.g.* lower levels could represent lower demand because of country-level factors) the gap between large and small firms *is* a reflection of the disadvantage faced by small firms in these countries. In countries with a greater supply of capital to SMEs (OECD) we observe that the rates of external financing are much more similar between large and small firms.

Figure 10: Use of external financing for working capital is low in all four countries studied



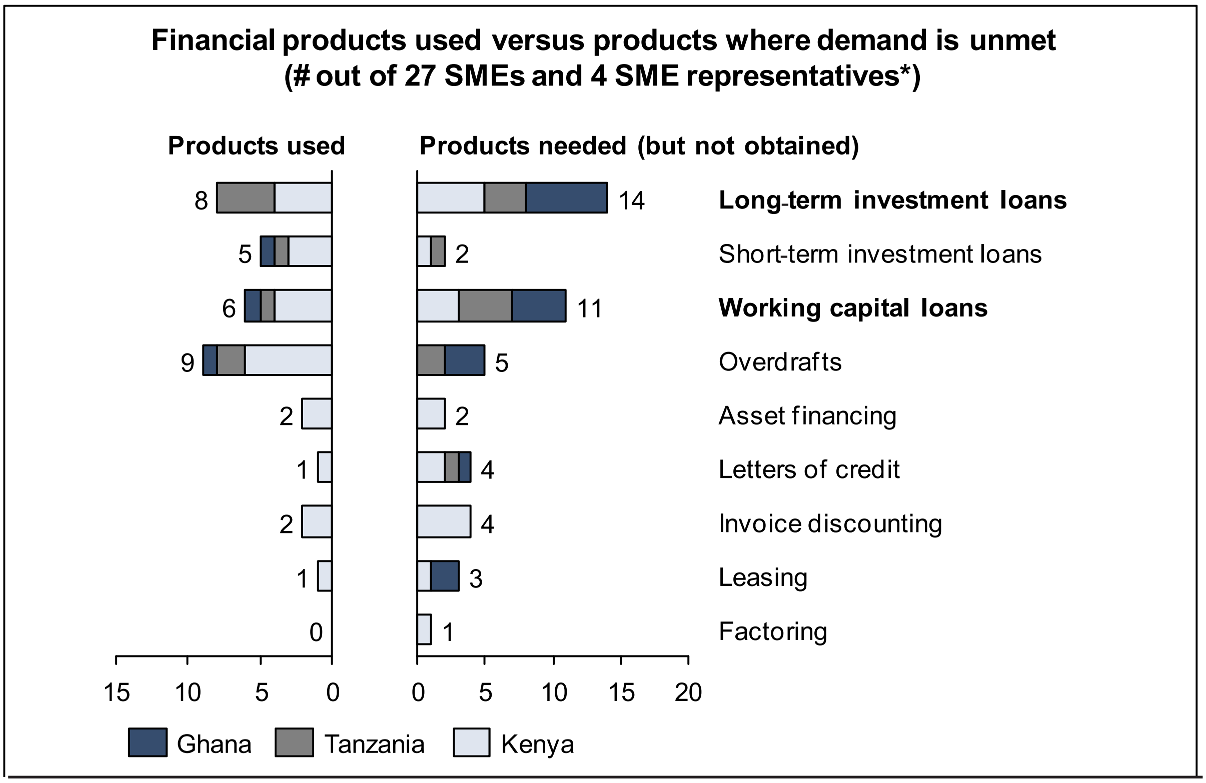
Source : 2005 - 2009 World Bank Group Enterprise Surveys.
Uses latest date available for 15 OECD countries and 37 Sub-Saharan African countries.

Although working capital is emerging as a critical need for SMEs, and banks are beginning to recognize this, there are significant barriers limiting the widespread use of sophisticated working capital finance. Banks cited a range of obstacles in the business environment, *e.g.* legal frameworks or inefficient judicial systems that prevent SMEs from using their inventories and accounts receivables to secure working capital loans. This is unlike the situation in developed financial systems, where the use of accounts receivables and inventory is standard practice. Given weak legal systems and the fact that invoices are often not considered legally binding documents, banks may be reluctant to accept invoices as collateral. This is important because banks are particularly worried about "diversion" risk – when working capital provided to SMEs is not linked to the productive activities represented by the invoices posted as security, or when funds received from paid invoices are not channeled back into loan repayment.

Some banks, especially those with large corporate clients, are crafting solutions in supply chain finance aimed at mitigating the legal hurdles and the risk of fund diversion by SMEs. An example solution would be for corporate customers of SMEs to channel payment for invoices through the banks providing the finance. These solutions are described in greater detail in section 2.4.

Overall, there is a need for capacity building and other interventions at the banks in order to help them meet the working capital needs of SMEs. In some cases, this may be as basic as educating the banks themselves on the use of working capital loans. It is interesting to note that banks in Ghana and Tanzania are fairly unsophisticated in their product offerings, and as such, most of their borrowers do not know about the possible use of products like invoice discounting (see figure below).

Figure 11: Working capital and long-term loans are cited as the greatest unmet SME-finance needs



Source: Stakeholder survey results in Ghana, Kenya, Tanzania.
** SME representatives asked to cite only areas of unmet need.*

Note: While we did not collect parallel data in South Africa from SMEs, we found (from interviews and previous studies) that the range of lending products typically available to SMEs is much larger in South Africa, and that loan durations are longer. But as noted previously, the external financing of working capital is still relatively low, and there are still barriers to the use of inventories/accounts receivable to obtain working capital loans, especially for smaller firms.

2.2. Limited provision of long-term capital

The need for longer-term loans was the other most-cited unmet need of SMEs in Kenya, Ghana and Tanzania. The median loan duration in these countries is three years or less, with most banks in Tanzania offering loans of only 1 to 2 years.[7] In comparison, SME loans in South Africa average 5 years in duration, and SMEs have access to a range of alternative lending products from Non-Bank Financial Institutions. However, South African banks still do not always tailor their product offering to the needs of SMEs.
Risk is the main contributing factor to the lack of long-term

[7] It is reported that only one bank in Tanzania provides firms with loan maturities exceeding three years.

loans, as banks believe that lengthy lending periods are very risky. It is likely, however, that this perception of risk may be more a reflection of banks' worries about the general macroeconomic and political risks, rather than that of SME risk. This is indicated, for example, by the fact that median loan maturities are the same across firm sizes in each country. SMEs also share some of these fears and sometimes do not want to commit to what they perceive to be high interest rates over a long period of time.

In Ghana, long-term loans were the most-cited unmet borrowing need of SMEs. Experts and firms there explained how the lack of long-term financing options has been detrimental not just to SMEs' ability to make large investments, but to their overall access to credit. In the absence of other options, SMEs in Ghana have attempted to use short-term financing to finance long-term investments, not properly assessing the difficulty of repaying the loan over a period of time that is not compatible with the payback period of the investment itself. As a result, these firms have been unable to make loan repayments that otherwise would have been manageable if stretched over a greater length of time. This has led to higher SME default rates, which in turn has reinforced bank perceptions of the high-risk nature of the SME sector, thus contributing to a vicious cycle of limited financing to the sector.

It is important to note that banks may not ever be well-suited to meet all the long-term capital needs of some firms, especially start-up firms. It is therefore critical to develop other sources of financing, such as venture capital and other complements to bank finance, in order to fully meet SME long-term investment needs.

2.3. Bank conservatism

While there is some variation in approach to lending to SMEs, and signs that things are changing, banks in the four countries studied are generally conservative when lending to SMEs and focus primarily on traditional approaches to lending. Bank conservatism has traditionally been bolstered by the profitability of lower-risk markets and the lack of competition from other types of financial institutions.

Banks in Africa have traditionally made money lending to the government and large corporates – with relatively minimal effort – as compared to the SME market, which requires new perspectives. In South Africa, consumer credit-card lending also provides an easier opportunity for banks to make profits than SME-lending. In Tanzania, there is a general view among banks that there are more people willing to borrow than banks willing to lend, and as such, banks in Tanzania can still cherry pick the best SME clients. This is unlike Kenya where intense competition is causing banks to seek innovative ways to serve more SMEs.

The limited or complete lack of significant non-bank financial institutions, such as leasing companies and factoring houses, further exacerbates the problems caused by bank conservatism. Banks are not facing competition from non-bank financiers as is the case in developed countries. Tax and regulatory issues can hinder the development of these alternative financing options. For example, in Kenya, leasing has more tax disadvantages than bank loans. These non-bank financial institutions may also be unable to obtain cheap capital; the high cost of capital can therefore force them to price their products above affordable market rates. SMEs that have attempted to use some of these products cited that they are typically very expensive.

A leading Ghanaian bank gets "burned" and retreats to a more conservative approach to SMEs

Ghanaian banks can generally be split into two groups: those who want to work with SMEs but take a very cautious approach to serving them, and those who want to work with SMEs and are willing to taking some measured risks to do so. One of Ghana's largest banks appears to have moved from the latter group to the former. A few years ago the bank developed a business instalment loan product for SMEs to be managed on a portfolio basis. The bank made a large number of SME loans requiring very low collateral (around 15%), and compensated for the risk with high interest rates. Unfortunately SMEs defaulted in large numbers and the bank made large losses on that portfolio. Today, the bank is interested in lending more to the sector, but wants to assess and serve each SME on an individual basis, providing fully secured loans, rather than experimenting with unsecured lending or models to serve SMEs in aggregate. Their more conservative approach to SME lending will lead to a slower growth of their SME portfolio, but ensures that they can cherry pick the SMEs they want to work with.

2.4. Bank adaptation and innovation

Most banks believe that SMEs are an important sector, but paradoxically, most banks are still very conservative in their approaches. However, there are some banks in each market studied that have recognized the strategic value (in terms of capturing market share) of adopting new and innovative approaches to serving SMEs. These approaches include developing new products that match the seasona-lity of SME operations, finding ways to use alternative forms of collateral (beyond landed property), and leveraging their corporate clients in providing supply chain finance.

Alternative forms of collateral

Landed property is still the dominant form of collateral employed by banks when lending to SMEs, but we found evidence of banks seeking to reach a wider market by accepting other forms of security. Banks (even those outside of South Africa) appear to be growing more comfortable with asset financing, especially for vehicles but also for other moveable assets, with the more aggressive banks willing to finance up to 80% to 90% of the value of an asset, rather than the more common 50% to 60%. Some banks in all four countries report offering debenture loans secured by an aggregation of the company's existing assets and/or debts receivable; a note of caution is warranted, however, since a bank's list of available products does not always reflect its actual lending practices. Only one SME interviewed actually reported having a loan secured by an asset debenture, and banks admitted that this type of lending, as well as inventory financing, is still rare.

On the other hand, some banks are finding ways to do away with collateral requirements altogether, below a certain threshold. Ghana's Fidelity Bank has a personal-loan product that enables entrepreneurs to obtain unsecured loans under $20,000. And Stanbic/Standard Bank is working on an under-$50,000 unsecured loan product that utilizes psychometric testing of entrepreneurs (see box further below).

Supply chain financing

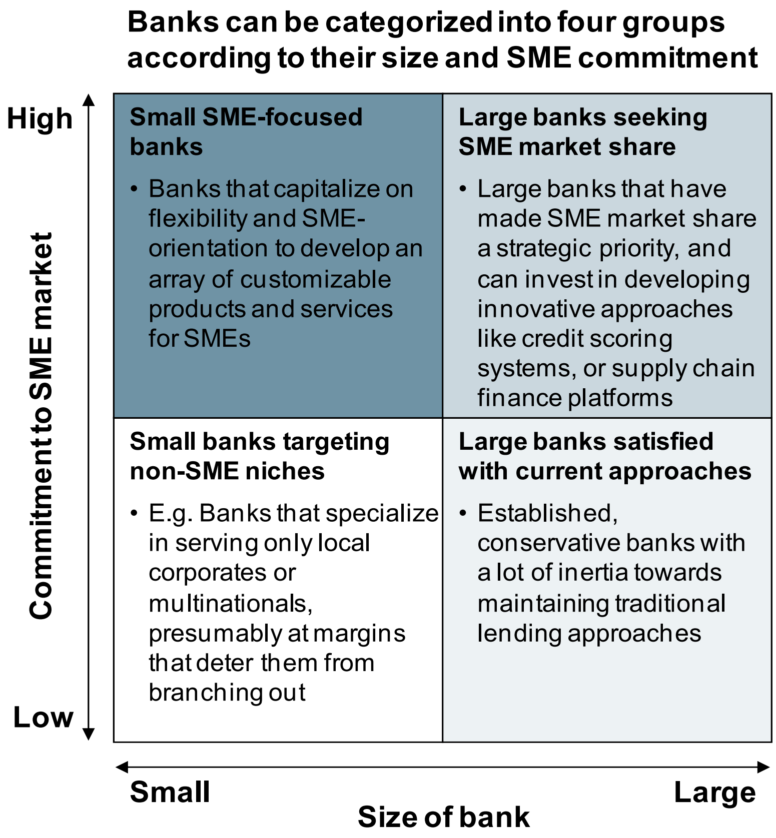
Another area where banks are attempting to expand their product line is in supply chain financing. Banks recognize that SMEs that are suppliers or distributors for large corporate firms should be able to leverage their relationship to these firms to access more credit. However, the banks typically do not trust the current business environment and legal system to provide sufficient recourse for loans grounded on vendor relationships; therefore, banks have been hesitant to use purchase orders and invoices (accounts receivable) as the basis for lending. In response, some banks are attempting to develop their own solutions to reduce risk or to augment their recourse to available options. A Kenyan bank with a large corporate client base, for example, is developing a technology platform that addresses SME diversion risk in invoice-based credit by: enabling the bank to receive invoice payments directly from the corporate client; collecting the bank's share for loan repayment; and then depositing the rest into the account of the SME. Thus, the bank can lend to SMEs based on the more manageable risk associated with the corporate client payment. The model can be extended to purchase-order finance – lending before an order is filled – by focusing on the corporate client to assess and mitigate SME performance risk. The bank is hoping to offer this platform as a service to other banks as well. This would be particularly valuable for smaller banks that serve SMEs but do not have direct access to large corporate clients in their supply chains. In Ghana, representatives of a large multinational bank reported that they are also developing a similar system to triangulate between corporate clients and SMEs, in order to increase their ability to reach SMEs.

It is worth noting that credit guarantee schemes are not typically linked to specific lending innovations like these. However, the Kenyan bank above indicated that such a risk-sharing arrangement – the provision of guarantees for loans made under the new platform (during an initial experimentation period) – could accelerate the rollout of the new platform and would be a compelling offering for a bank that is otherwise quite skeptical of credit guarantee schemes.

Different approaches by bank size

We noted in our research that both large and small banks – very different types of institutions – can find ways to adapt and deepen their services to the SME market by leveraging their particular institutional advantages. The diagram below categorizes banks in the countries studied into four quadrants based on their size and appetite for the SME market, and it describes the differences between the four types observed. Smaller banks were divided between those for whom SME banking was a key part of their identity, and those primarily targeting some other market segment, such as large corporates or high-net-worth individuals. Large banks included those that seemed disinclined to depart from their current business model (which has served them well for generations), as well as those who see SMEs as one of the last frontiers for seizing market share and are motivated to find a way to do so.

Figure 12: Banks eager to serve SMEs leverage institutional advantages to address unmet needs



Source : Dalberg Analysis

Banks for whom the SME market was a strategic priority consistently reported that new products, approaches or lending models were under development. We found that the larger banks were able to draw on their significant resources to undertake big research and development projects aimed at finding new lending models that more efficiently assess credit worthiness or utilize new forms of collateral. Smaller banks, on the other hand, leveraged their relative "closeness" to their SME customers to continually adjust and add to their SME product offering based on customer feedback. This might also include emphasizing literal "closeness", by aiming to open new branch locations where SMEs conduct business. In this sense, it appeared that large banks were focused more on the challenge of risk-assessment and risk-management, and smaller banks on better meeting customer demand.

Standard Bank uses mobile technology and economics research to reach small firms*

One of Africa's largest banks provides an example of utilizing research and development to identify better ways to measure SME risk and extend the reach of its operations. Standard Bank (Stanbic) has been testing a new lending approach in Ghana, Kenya, Nigeria and Tanzania, initially targeting micro- and small enterprises in trader markets. After segmenting the possible customers in this space, from importers to wholesalers, retailers and market traders, the bank sent loan officers into the markets to begin making loans between $300 and $30,000. The approval of these loans is enabled by a credit assessment tool developed in a Harvard University research lab, which employs a 30-40 minute psychometric test of attributes of the entrepreneur statistically linked with credit worthiness. (The test only works for owner-managed firms, but this characterizes the majority of SMEs in Africa). The loan officers conduct the test on-site using mobile devices and then link the customers with local branches.

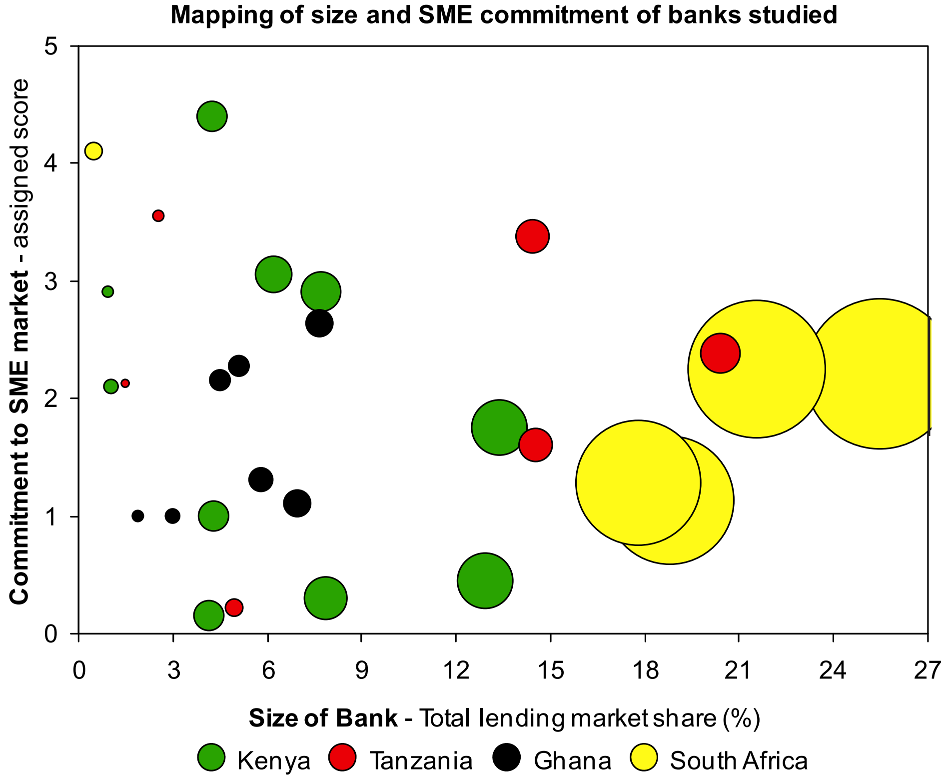
Though this new lending model is still in early stages, initial results – from a reported $30 million in lending to over 4,880 firms – appear promising. The bank has seen increased approval rates and lower transaction costs to serve a segment that it was once largely unable to reach. As the businesses grow, their borrowing history with the bank can serve as the basis for larger loans. Already 556 SMEs have received a second facility after paying off their first loan. While it is too early for conclusive analysis, default rates have been low to date, and the bank may look to expand this product offering to a wider set of customers. Standard Bank believes its new approach to the SME market can unlock access to a massive quantity of previously unmet demand.

**Information sourced from, or confirmed by, publicly available documentation, including web postings from test creator Entrepreneurial Finance Lab; Lending and borrower volumes from The East African, "Psychometrics tests for loan product", 27 November, 2011.*

Mapping banks by commitment to the SME sector and bank size

To illustrate the range of banks' commitment to reaching SMEs, we developed a means of scoring banks based on: their share of lending to SMEs; use of partnerships to expand their service to SMEs; and active development of a new lending product or approach to serving SMEs. We then plotted the results according to each bank's commitment score and its size. The results (shown in the following figure) illustrate the wide range of banks' appetite for lending to SMEs, and confirm that there are banks falling into each of the four quadrants in the framework presented earlier. In other words, because both small and large banks have characteristic ways of pursuing the SME market, there is no strong correlation between bank size and commitment to SMEs. The diagram serves merely to map the observations of the banks studied, rather than to draw any strong conclusions.

Figure 13: Appetite for the SME sector is not dependent on bank size



Bubble size represents total portfolio, but SA bubbles have been reduced by a factor of ten in order to fit.

Note: SME commitment score based on reported/estimated % of SME lending, presence of partnerships to expand SME lending, and initiatives to develop new lending products/approaches for SMEs; market share data for South Africa are based on total assets.

Source : Dalberg Analysis

As a side note, the figure above is helpful in visualizing the differences between SME financing in Kenya – where there are both extremely conservative and extremely innovative banks – and Ghana, where every bank seems to have some plan for reaching SMEs, but fewer banks are pushing the envelope in terms of innovative approaches. In South Africa, the market is dominated by four very large banks, and as such, each has at least some level of commitment to SMEs.

3. The Credit Guarantee Landscape

3.1. The role of credit guarantees in SME access to finance

Credit guarantees are a solution that has been used by a range of actors to address bank concerns regarding the risk of lending to SMEs. While banks generally do not perceive credit guarantee schemes to be the "single most important tool", those we surveyed generally do feel that they can be a viable way to increase lending to SMEs.

At its simplest, a credit guarantee is an agreement whereby a guarantor shares the risk of borrower default with the bank. Guarantee providers typically define target borrowers or loan features, charge a fee for the service, and use one of a range of default coverage models. Purely market-oriented guarantees are similar to insurance policies driven by bank demand, but most providers of guarantees we studied are motivated to increase bank lending to SMEs for development purposes, and are at least partially supply driven. These providers can include donors, foundations, national governments, and multilateral development institutions. Many are also involved in providing guarantees linked with microfinance, but we restrict our study to the SME sector.

Credit guarantees are considered to be relatively more efficient than some other interventions for SME finance, such as lending money to banks at concessionary rates in order for them to target specific borrower types. "*Directed credit programs and credit subsidies with the aim to alleviate SMEs' financing constraints have rarely had the expected success, due to mis-targeting, rent-seeking and lack of fiscal sustainability*" (Beck *et al.*, 2008). Credit guarantees are not the only alternative to these approaches. Other interventions include DFIs (Development Finance Institutions) making long-term investments in banks for the purpose of growing their SME portfolio, and institutions providing risk-sharing in the form of co-investing with banks. We focus on credit guarantees because they are one of the most common tools applied across the developed and developing world.

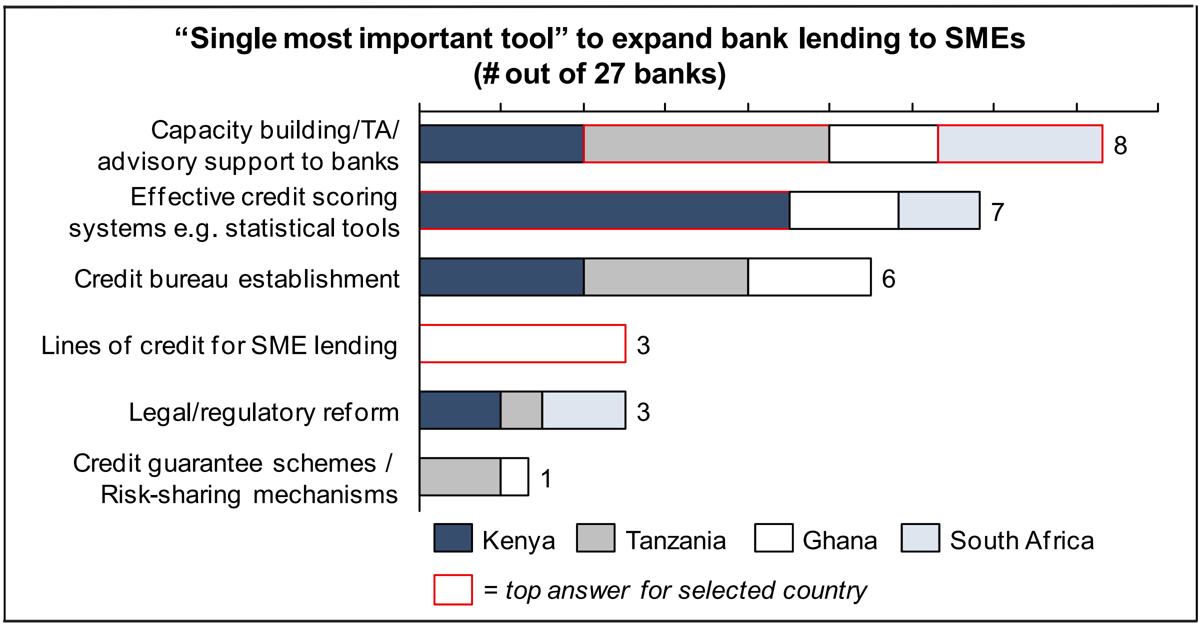
The primary mechanism through which a guarantee works is to lower the expected risk of default on a loan, thereby changing the bank's calculation of whether that loan is a worthwhile investment. Based on this concept, guarantee programs have become a permanent fixture in many economies (see, for example, Small Business Administration loans in the US) on the grounds that SME lending has positive externalities and will never be provided in sufficient volume by the market alone.

However, the aim of other credit guarantee schemes is to catalyze a change in the market itself. Especially for many donor-funded entities, the ultimate goal of a CGS is for banks to actually change their strategic or operational behavior in a way that permanently increases SME access to finance. This goal is predicated on the belief that banks overestimate the risk in lending to (certain groups of) SMEs, or are unwilling to invest up front in the operational changes needed to serve the market, but will continue to serve SMEs once they have gotten their "feet wet". The behavior changes intended by these schemes may include banks targeting new types of customers (such as agribusinesses), offering more favorable terms (*e.g.* loosening collateral requirements), or increasing their product offering to meet SME needs.

To varying degrees, both the banks and the SME-finance experts agree that credit guarantees are not the most important tool for expanding bank lending to SMEs. However, there is evidence to suggest that CGSs can complement other efforts and can accelerate bank progress in the SME market. Figure 13 below presents bank perspectives on the most important means for increasing lending to SMEs. Capacity building for banks receives the broadest support across the four countries studied. This is consistent with the views of experts that the SME market requires a different way of doing business, and banks need to engage in re-learning throughout their organizations. However, the survey results also likely reflect banks' strong desire that technical assistance be provided to SMEs, and the notion that banks have had to bear too much of this burden.

Other top approaches for expanding bank lending to SMEs reflect conditions in the different markets studied. In Kenya and Ghana, credit scoring is the top-ranked tool because banks are sophisticated enough to understand the need for better ways to assess SME risks, but only a few have developed the necessary systems. Similarly, credit bureaus are seen as critical in Ghana, Kenya and Tanzania, given local issues with serial defaulters, but not in South Africa, where such bureaus are already fully operational. Not covered in the survey – but cited in interviews by a number of experts and SME representatives – is the importance of fostering a competitive environment in which non-bank finance institutions can provide alternative sources of finance.

Figure 14: Capacity building, credit scoring and credit bureaus seen as keys to expand SME lending



Source : Bank survey results in Ghana, Kenya, South Africa and Tanzania.
(Fractions result from weighting multiple survey responses for the same bank)

Banks ranked credit guarantee schemes last in terms of the "single most important tool" for expanding SME lending. However, in answer to an earlier question about *limitations* to bank lending (see Figure 8) "lack of effective risk-sharing solutions" was the second most-cited obstacle. There are two likely explanations for this. The first is that while CGSs are not the *most* important tool, they still address an important need in the market. The second is that credit guarantee schemes have not fulfilled their potential to foster SME lending. Our findings suggest that both of these explanations have merit.

Along with banks, SME finance experts are likely to cite the greater importance of solutions that enable banks to fundamentally change the way they assess risk and serve the SME market. In the extreme, credit guarantees are viewed as merely a "band-aid" solution.

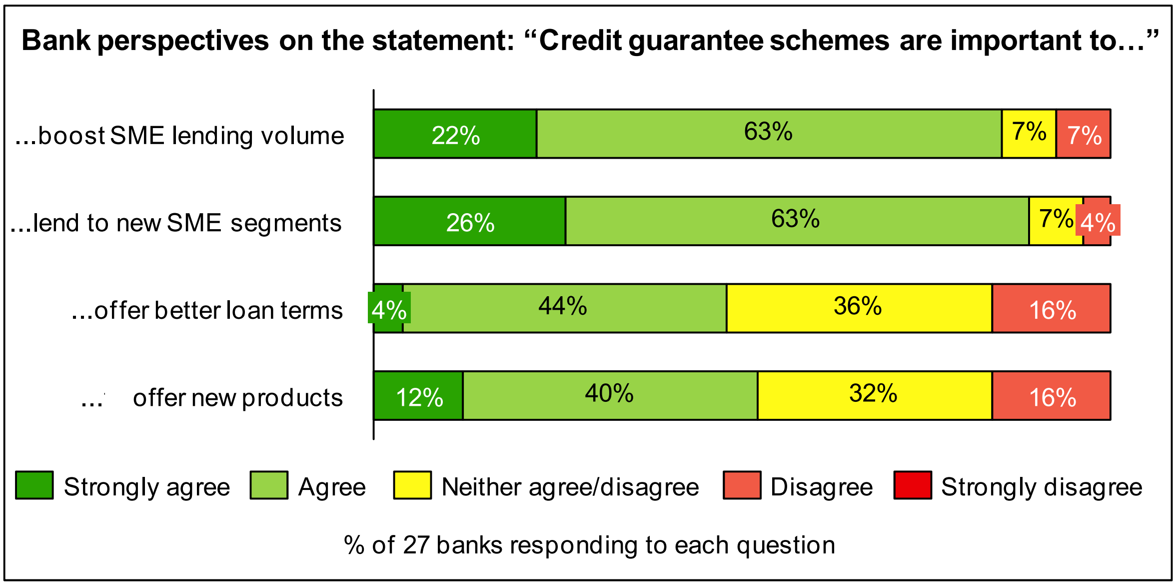
> *"Credit Guarantees have been used as a band aid over the problem [of banks not knowing how to assess SME risks]. The main solution is to provide infrastructure that solves the information asymmetry problem* e.g. *credit bureaus... and to help banks develop cost effective ways to filter potential customers."*
>
> – Head of a donor-funded program to increase SME access to finance

However, many banks and other observers do believe that credit guarantees can be useful in filling gaps in the near term and potentially catalyzing bank entry into new markets. The key to fulfilling this potential lies in how guarantees are designed and implemented, and the degree of collaboration between banks and CGS providers. (These issues are discussed in the remainder of this section.)

> *"Credit guarantees have been useful to us because they give a better understanding of the sector. They helped make us more comfortable in an area where we were previously not operating".*
>
> – Head of New Product Development, large Kenyan bank
>
> *"Credit guarantee schemes, if properly packaged, can be very helpful in addressing gaps in the market."*
>
> – Former CEO of Ghanaian commercial bank

The figure below presents bank perspectives on the role and importance of credit guarantees. There is general agreement that credit guarantees can help banks reach new market segments and increase the volume of the SME lending. Consistent with other findings discussed later, guarantees to a lesser degree are perceived as having an impact on lending terms and new product development.

Figure 15: Banks generally perceive CGSs as a useful tool

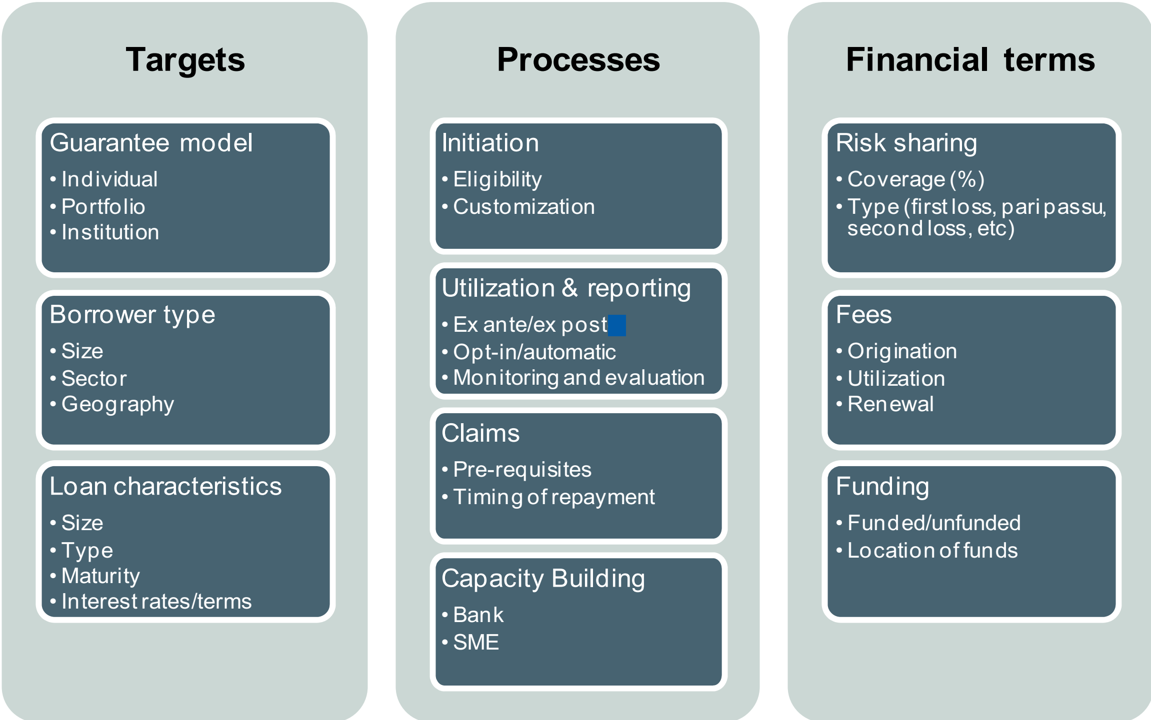


Source : Dalberg Analysis

3.2. The offering of credit guarantees in the countries studied

Previous studies have employed a range of approaches to categorize credit guarantee schemes (Deelen and Molennar, 2004; Navajas, 2001; Beck *et al.*, 2008), but these are limited in their ability to simply and comprehensively describe the landscape of guarantee schemes observed in Ghana, Kenya, South Africa and Tanzania. Therefore, we use a descriptive framework that consists of three basic dimensions: (1) targets; (2) processes; and (3) financial terms. The figure below shows the major components that make up the three dimensions. A given CGS can be distinguished by its component features in each of the three dimensions.

Figure 16: A descriptive framework for assessing the offering of credit guarantees



Source : Dalberg Analysis

We have used this framework to identify correlated features for any given guarantee model, to analyze the current offerings pertaining to guarantees, and to characterize the provider landscape.

3.2.1. Features of major guarantee models

There is a strong correlation between specific guarantee features across the various dimensions. In particular, the guarantee model is often linked with certain initiation and utilization processes and fee structures, and to a lesser extent with risk-sharing approaches. Below, we describe some of the distinguishing features of the different guarantee models.

Individual loan guarantees

Individual guarantees that we observed usually involve the CGS provider in the assessment of loans, often – although not always – after a referral by the bank (*ex post)*. The initial process for a bank to become eligible to use the guarantee is usually shorter, but the loan approval (utilization) process takes longer because of duplication in the assessment (by both the bank and the CGS provider). Additional reporting requirements are usually reduced. Both guarantee coverage and fees were observed to be higher for individual guarantees. A number of banks and observers have questioned whether duplication of credit assessment in individual guarantee programs is necessary as long as the bank – which possesses greater expertise – is making a good faith effort on its own behalf to assess the risk.

Portfolio guarantees

Portfolio guarantees generally have more flexible target borrower/loan characteristics, because they rely entirely on the bank's loan approval processes. Utilization is therefore faster – bank-approved loans with certain features are either automatically guaranteed or there is a process for the bank to opt in to the guarantee for a given loan. But initial eligibility processes and reporting requirements tend to be more involved. Fees for portfolio guarantee schemes are likely to be lower (see table below), reflecting the reduced administrative burden on the CGS provider. But unlike individual guarantees, the portfolio guarantees observed rarely provide more than 50% risk sharing, likely reflecting the fact that guarantee providers do not screen the individual loans. Portfolio guarantees can also be issued to investment funds – either as equity or debt guarantees – as in the case of Root Capital's[8] DCA guarantees.

The table below compares fees for portfolio and individual guarantees, where data were available, in the four countries studied. The fee structures have been simplified to allow for comparison across schemes, but most fees can be categorized as either (1) fixed-origination fees; or (2) annualized (through various methods) utilization fees charged on the outstanding balance guaranteed. One distinction is hat origination fees for portfolio guarantees are charged ased on the targeted total lending, whereas pfront/origination fees for an individual loan guarantee (which are rare) are linked to the actual loan disbursement. As would be expected given the relative transaction costs, the fees for portfolio guarantees are on the whole lower than for individual schemes.

Table 2: Comparison of fees for individual *vs.* portfolio guarantee schemes

Guarantee model	Guarantees with fee data available (#)	Origination fee (upfront fixed fee)			Utilization fee (annual fee on balance)		
		Min.	Max.	Median	Min.	Max.	Median
Portfolio	19	0%	1%	0.5%	0%	2%	0.5%
Individual	13	0%	3.5%	0%	0%	4%	2%

Source : Dalberg Analysis

Note that this assumes that portfolio schemes achieve a reasonable amount of the targeted lending, and that the data are not biased by significant differences in the market-orientation of the providers using each model.

Institutional guarantees

Institutional guarantees are actually more common in the microfinance space, where a guarantee provider issues a portable or bond guarantee directly to an MFI, so that it can raise bank or public financing, respectively. We did not observe active institutional guarantees for SME finance, but we mention them here because a number of experts pointed to the potential for providing guarantees to the non-bank financiers of SMEs – this would enable them to raise lower-cost capital and fill gaps that banks are not addressing, such as in the areas of factoring, leasing and venture capital.

3.2.2. Active guarantee programs

The table below provides a list of the active, individual SME-loan guarantee programs and SME-focused portfolio guarantee providers in the four countries studied, as of June 2011. These include a few very-targeted programs, such as those designed to boost agricultural and school lending, where the target borrowers would be considered SMEs. We excluded all guarantees targeted at microfi-

[8] Root Capital is designated as a social investment fund, though it primarily provides debt finance rather than equity.

nance or MFIs, although some of the borrowers in the programs below might be considered microenterprises.

In each country, there are between 1 and 5 active individual loan programs, and 1 to 4 active portfolio guarantee providers. It is worth noting that every portfolio guarantee involves at least one international provider (with cross-country guarantee experience), whereas individual loan-guarantee programs are more likely to involve national organizations or be part of a nationally focused program.

Table 3: Active SME guarantee programs and providers (June 2011) in the four countries studied

Country	Active individual loan guarantee programs/providers	Portfolio guarantee providers with active guarantees
Ghana	AFD (ARIZ) Eximguaranty – founded by GoG Garantie des Investissements en Afrique de l'Ouest (GARI) IFC – short-term funding for Ghana cocoa sector Millennium Development Authority Agri-credit Program – linked with MCC	AFD (ARIZ) AGRA-MDA IFC USAID (DCA)
Kenya	AfDB/ILO/IFC Growth Oriented Women's Enterprise (GOWE) program AFD (ARIZ)	AGRA-IFAD USAID (DCA) USAID (DCA)/World Bank AFD (ARIZ) – in progress
South Africa	Khula Credit Indemnity Scheme – founded by GoSA Industrial Development Corporation – Thembani International Guarantee Fund AFD (ARIZ) – past guarantees still active	USAID (DCA) Enablis Khula Loan Fund Kwazulu-Natal Provincial Government BEE SMME founded by GoSA Loan Guarantee Facility
Tanzania	Bank of Tanzania SME CGS – GoT program Private Agricultural Sector Support (PASS) – founded by GoT/Danida Rabobank Sustainable Agriculture Guarantee Fund (SAGF) AFD (ARIZ) AFD (ARIZ) – in progress	AGRA-Kilimo Trust AGRA-FSDT USAID (DCA)
Additional	IFC has the ability to provide guarantees in all four countries, but they do not have currently active SME-focused guarantee schemes/programs outside of Ghana Cross-country guarantee providers just launching operations include the European Investment Bank (EIB) and the African Guarantee Fund (initiated by AfDB/Danida) DFIs like FMO and IFC provide other types of risk-sharing designed to benefit SMEs, including co-financing and trade finance guarantees (bank-to-bank); these are not covered in depth because they are sufficiently distinct from credit guarantee schemes	

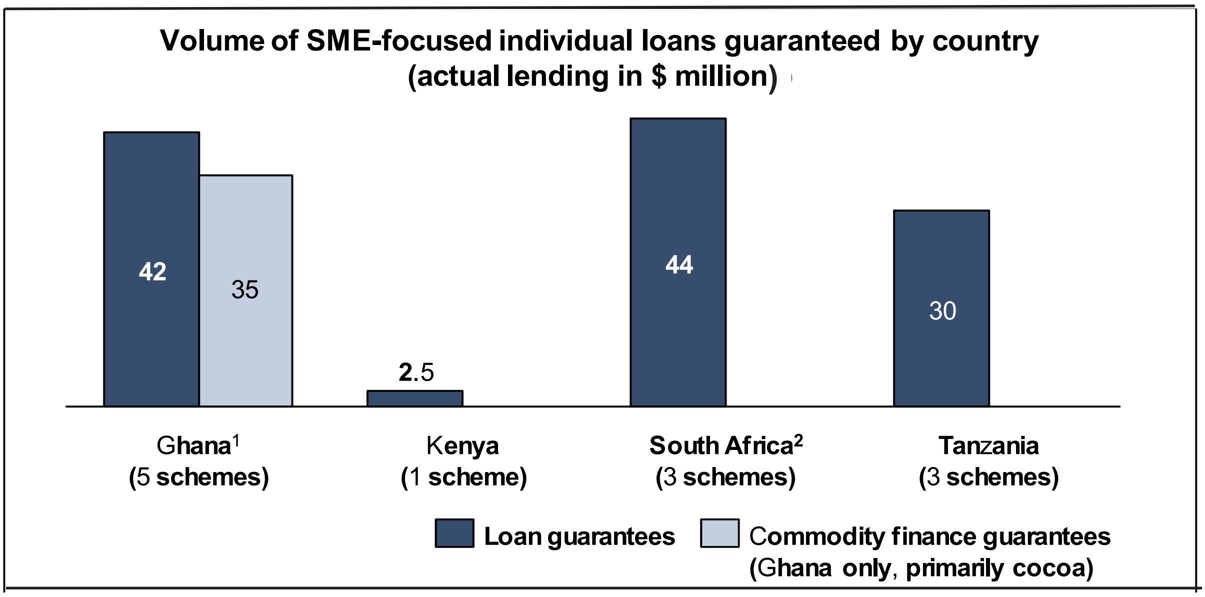
Source : Dalberg Analysis

In total for all four countries, we identified 36 active schemes comprised of 22 active portfolio guarantees (provided by a smaller set of guarantee providers), and 14 individual guarantee programs with loans on the books.

Quantifying individual loan guarantees

Individual SME loan guarantees in the countries studied can be difficult to analyze quantitatively because they may be bundled with other types of financing, or not clearly distinguished from other guarantee products like bid bonds and performance bonds. A number of guarantee programs were unresponsive to requests for information and, while banks provided useful information on their individual experiences with these programs, they did not have knowledge regarding the overall performance of schemes that involved multiple banks. Nevertheless, we were able to develop reasonable estimates of the volume of active loans guaranteed by individual loan guarantee programs in each of the four countries, as seen in the figure below:

Figure 17: Ghana and South Africa have the highest volumes of guaranteed individual loans



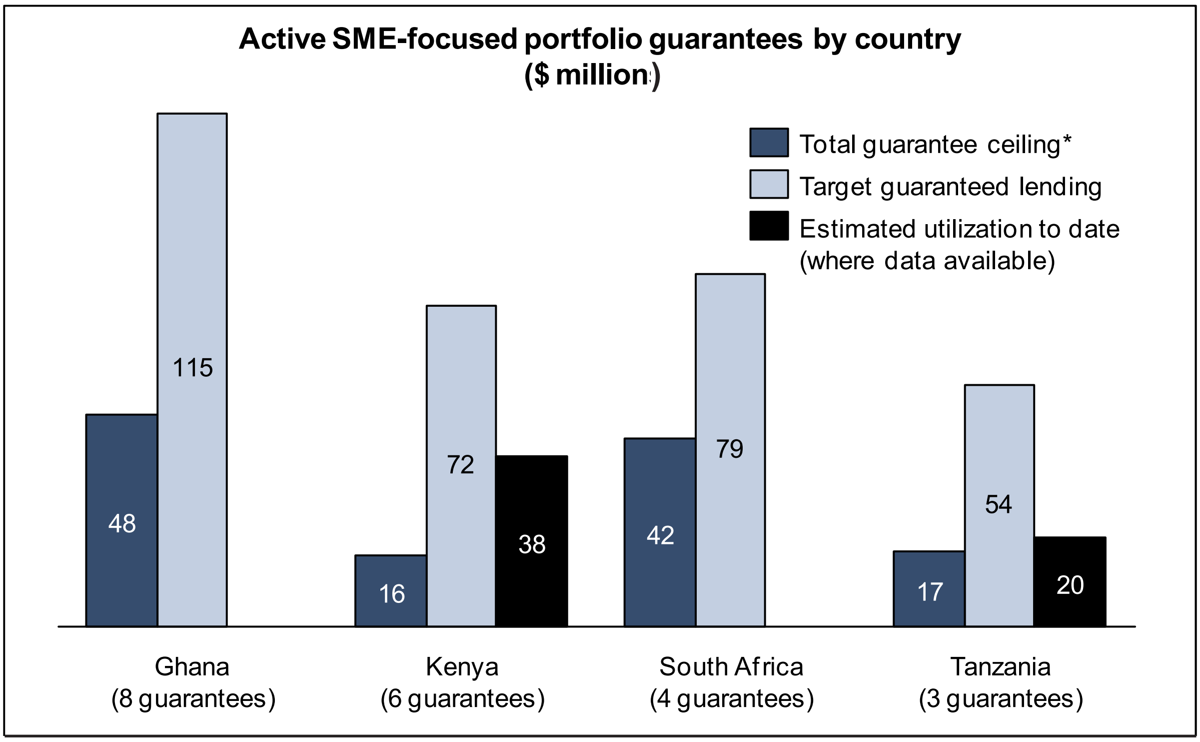
Source : Dalberg analysis
[1] Ghana data does not include Mutualist CGS for which data was not available, likely very small.
[2] South Africa data does not include IDC scheme.

In South Africa, which has a large volume of individual SME loan guarantees, government-founded entities provide the majority of the individual guarantees. The same is true in Tanzania, and in Ghana, where the government-founded Eximguaranty is a leading provider of individual guarantees. Kenya is the only country without any government-linked guarantee program, and it has the lowest volume of individual loan guarantees. The links between CGS provider type and guarantee features are further discussed later in this report.

Quantifying portfolio guarantees

From our analysis of the portfolio guarantees we identified in each country, we have tallied: the number of active agreements in place; the amount of guarantee funding committed (*i.e.* the guarantee ceiling representing the amount at risk from the perspective of guarantee providers); and the amount of lending targeted in each guarantee agreement. In Kenya and Tanzania, banks and guarantee providers were sufficiently forthcoming with data that we were able to estimate the actual utilization to date – note that in Kenya the portfolio guarantees were on average ~4 years old while the guarantees in Tanzania were on average ~2 years old. The figure below presents the results of this analysis.

Figure 18: Ghana has the greatest number and volume of portfolio guarantees



Source : Dalberg analysis; does not include $ 22 millions multi-country Root Capital guarantee agreement.
Guarantee ceiling is the total amount at risk for the guarantee provider, e.g, 50% of the guaranteed portfolio size in a 50-50 risk sharing arrangement.

Ghana has the highest portfolio-guarantee lending (both in committed and targeted funding) for any of the four countries, based on 8 active agreements. South Africa has the highest amount of guarantee funding per agreement, but a limited amount of guaranteed lending given the size of its economy. There are a number of possible reasons for the variation between countries, including:

- Path dependency – banks and guarantee providers build off of past guarantee experiences, so an early success can lead to a rapid expansion guarantees. In Ghana, Ecobank has been very receptive to portfolio guarantees and accounts for 4 of the 9 agreements, and $22 million out of the $50 million in guarantee funding committed. In Tanzania, portfolio guarantees are a relatively new phenomenon and are still building momentum. In South Africa, banks have faced challenges with the government's Khula indemnity scheme, which only pays claims at the end of recovery proceedings (possibly 2 to 3 years after default). This appears to have had a fairly significant, and negative, effect on the general attitude in the country towards guarantees.

- Country exposure limitations – Kenya has as many USAID guarantees as Ghana (5), but the average guarantee size is smaller, possibly reflecting country-risk profiling.

- Competitiveness of the guarantee offer – Guarantees in South Africa are competing with a host of other alternative interventions for financing SMEs, including a large variety of investment funds. Some banks in South Africa expressed that they were comfortable with their ability to manage portfolio risk (with default rates around 2%-3%) and preferred to finance riskier clients outside of their lending portfolios – *i.e.* off balance sheet/through subsidiary investment funds – rather than get involved with a guarantee scheme.

Risk-sharing approaches

The different leverage ratios observed in portfolio guarantee figures[9] reflect the relative weight of highly-leveraged, first-loss guarantees among the total active portfolio guarantees in a country. All first-loss guarantees observed involve the Alliance for a Green Revolution in Africa (AGRA) and its partners, in which the NGO guarantees 100% of losses up to the first 10%-20% of the portfolio. The goal of this arrangement is to provide a strong incentive for banks to use the first-loss arrangement while highly leveraging the investment by limiting total coverage. For example, an AGRA-Standard Bank guarantee agreement targets 4 countries and $100 million in lending *via* $10 million in guarantees. This program was announced in 2009 but has started slowly as the bank adjusts to serving a completely new market – including developing new organizational structures and training staff for agricultural lending – and dealing with pricing restrictions built into the guarantee. The highest utilization (as of mid-2011) has been in Ghana, where the portfolio reached 18% of the target size after operating for one planting season, and the bank hopes to lend more than twice that amount over the following year.

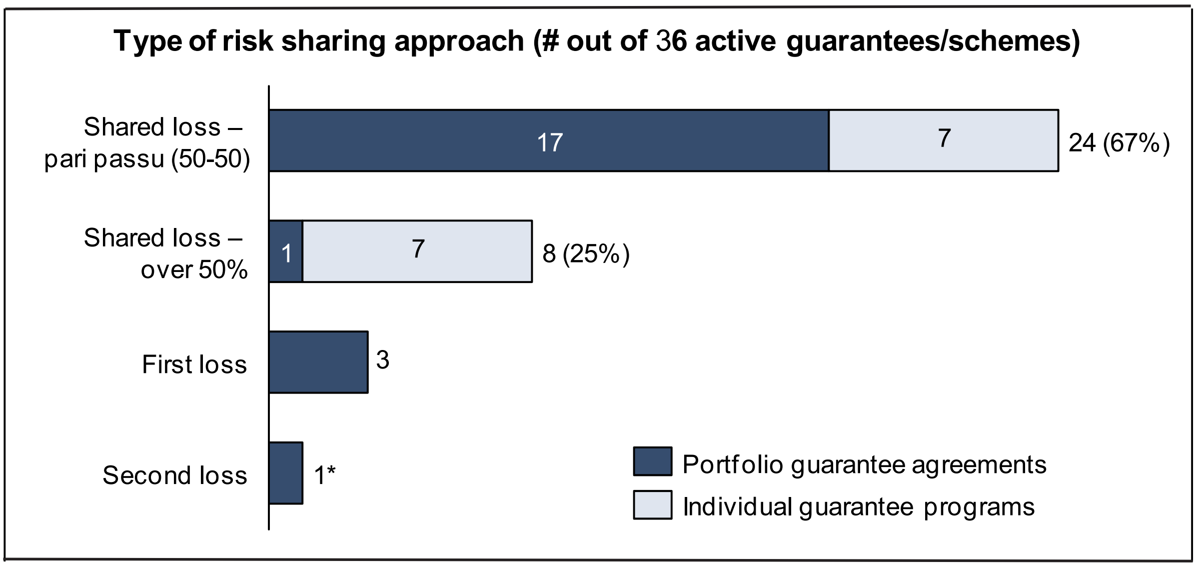
For all of the other guarantees, the risk sharing is either a split (usually *pari passu*) of the total losses or, in the case of some IFC "second loss" agreements, a sharing of losses that occur after the bank absorbs a first loss amount (typically 5%) reflecting normal default rates.[10] Shared-loss and second-loss guarantees offer lower leverage than a first-loss guarantee, and are less likely to be able to prescribe strict lending conditions (because they are generally less attractive to banks). However, they are perceived as reducing moral hazard by making sure the bank has enough "skin in the game" for each loan that it makes. *Pari passu* (50-50) shared loss is especially attractive because even when the guarantee is paid up front (in part or in full) the bank is expected to continue to attempt to collect or convert collateral. This is more likely to happen if the bank will get half of all that is collected rather than, for example, only a quarter in the case of a 75% guarantee.

Based on evidence from the current offerings in both individual and portfolio guarantee schemes in the four countries, it appears there has been a general convergence on the part of CGS providers towards *pari passu* sharing of total losses. These represent two-thirds (67%) of the total guarantee schemes observed. The second-most-common approach is over-50% sharing of total losses, accounting for one-quarter (25%) of the schemes. The figure below illustrates this.

[9] The amount of targeted lending to guarantee funding is 2:1 in South Africa, *versus* over 4:1 in Kenya.

[10] Note that these "second loss" guarantees, as well as first loss guarantees, are by definition linked to portfolio schemes.

Figure 19: ***Pari passu*** **(50-50) risk sharing appears to be the dominant approach**

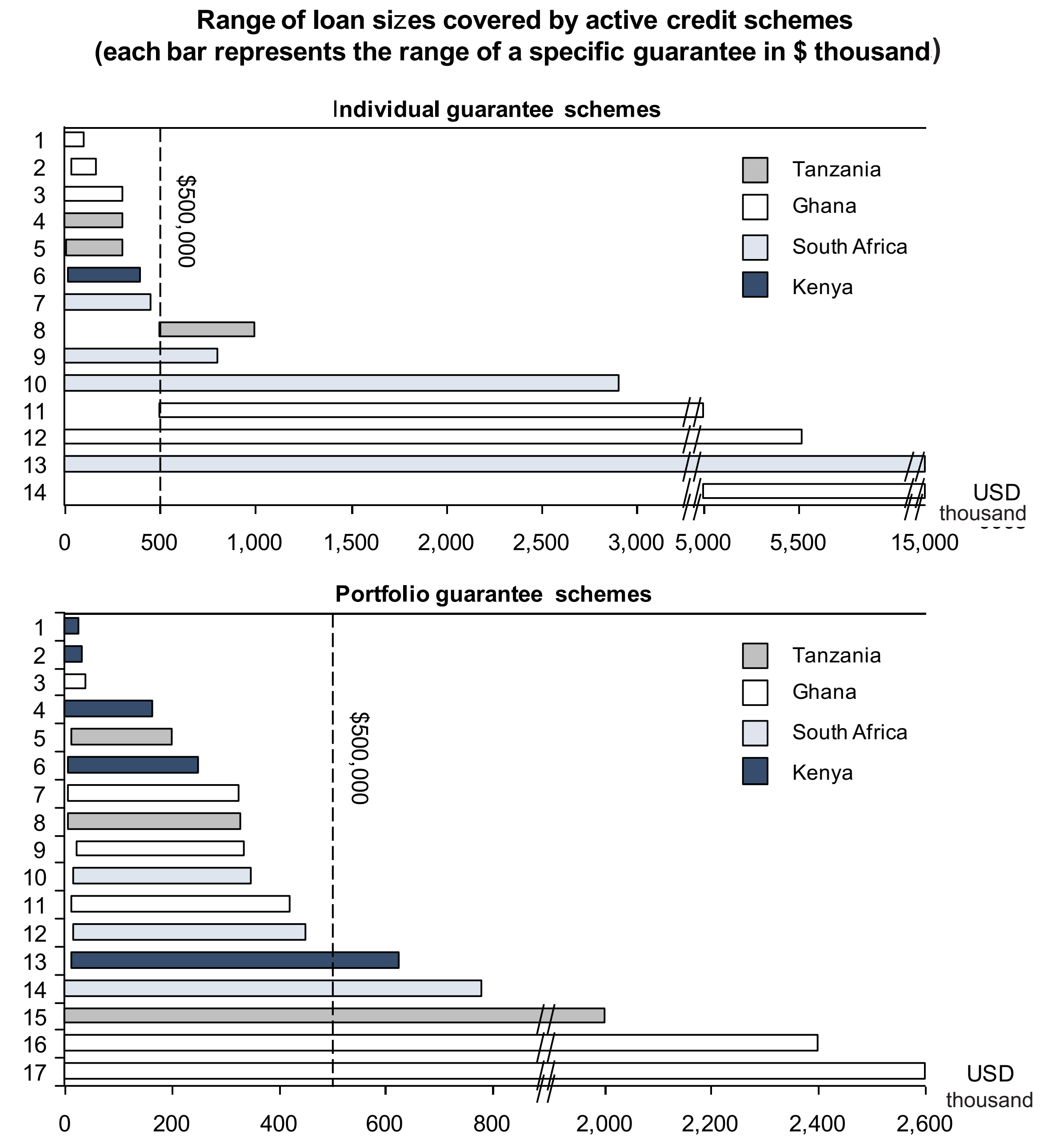


** Currently in its 3rd round of funding.*
Source : Dalberg analysis of CGS shemes.

Targeted loan sizes of active guarantees

The term "SME-focused guarantee" encompasses guarantees with a large variation in target firm sizes because of different bank and CGS provider definitions of SMEs, policy priorities of the providers, strategic priorities of the banks, and the practicalities of guaranteeing small loans. To reach certain customer segments, guarantees generally employ requirements on loan size (as a proxy) rather than actual firm characteristics like revenues or employees. Many guarantee programs – especially portfolio guarantees – base loan-size eligibility on discussions with the bank and the bank's own ways of segmenting the market. However, a number of programs establish firm limits that banks must accept as given. The figure below illustrates the variation in SME targeting by showing the loan-size limits, or ranges, covered by 31 guarantees in the countries studied. One clear conclusion from this charting is that individual loan schemes are more likely to reach larger SMEs than portfolio schemes. Of course, for both guarantee models, at least half of the guarantee schemes are targeted at loans of under $500,000.

Figure 20: Portfolio guarantees generally target smaller firms/loan sizes

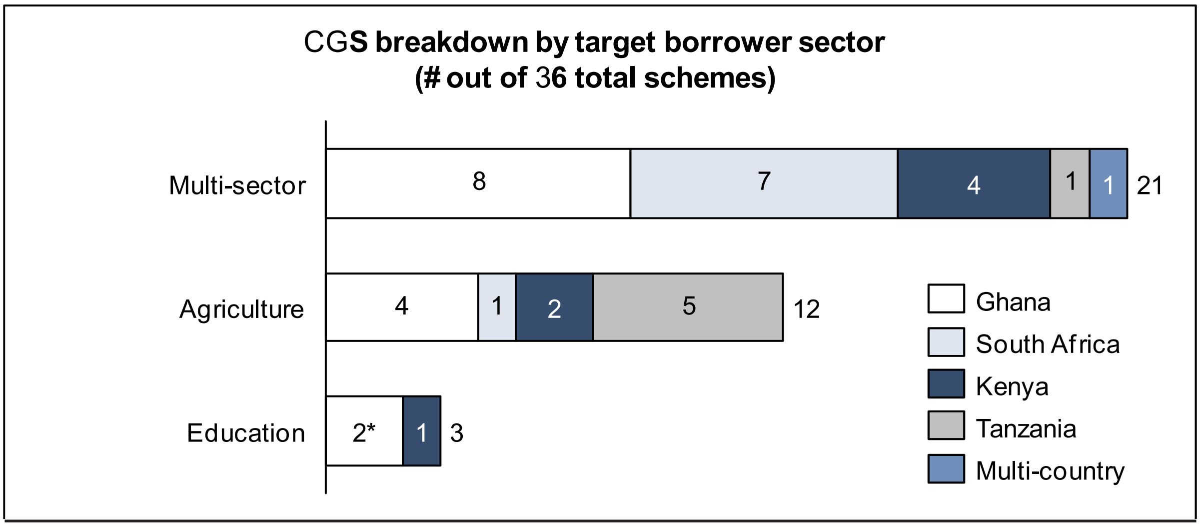


Source: Dalberg analysis of 31 active schemes for which sufficient data was available .
Note: Range typically represents the minimum and maximum loan sizes that are eligible under, or have been covered in practice by the guarantee. When no minimum specified, range begins at zero. In some cases, only average loan size was available, so the range was constructed using the average as the mid-point between zero and the maximum.

Sector targeting by active guarantees

Many guarantee providers work with banks to target certain types of borrowers, developing lists of priority sectors and occasionally seeking women entrepreneurs. On occasions when an entire guarantee program is focused on only one sector, that sector is typically agriculture. As seen below, nearly a third of active guarantee schemes in the four countries (and over 80% in Tanzania) are devoted solely to agriculture.

Figure 21: Most single-sector guarantees are targeted on agriculture



** Includes one guarantee in its 3rd round of funding.*
Source : Dalberg analysis of active CGS shemes in Ghana, Kenya, South Africa and Tanzania.

3.2.1 Characterizing the provider landscape

One way to better understand the offering of credit guarantees is to look at the different types of entities providing them. The guarantee landscape in the countries studied is characterized by five major types of providers, with certain characteristic tendencies in guarantee design. The five provider types also have different levels of market orientation, sometimes competing with each other to attract the interest of banks. The table below elaborates on these five types of providers and shows how they differ based on the major dimensions of guarantee schemes.

Table 4: The guarantee landscape is characterized by five types of providers

Provider type	Targets	Processes	Financial terms
Government-sponsored entity (*e.g.* Eximguaranty, Bank of Tanzania, Khula)	Typically individual loan guarantees Usually available to all banks in the country on a loan-by-loan basis Can be linked to other policy goals, sector targets etc.	Bank approves borrower and then submits request for guarantee approval to provider May be linked to TA as part of larger sector program	Often willing to guarantee large portions of risk, up to 90% in some cases Typically higher fees (~3%) that are built into loan terms Guarantee may directly substitute for borrower collateral
Mutualist / Member organization (*e.g.* Ghana MCGS, FABCOS)	Individual loan guarantee for contributing members of the organization May be difficult to exclude borrowers if they are members Relatively smaller loan sizes	Provider likely to be involved in assessing individual loans Loan may be linked with capacity building for SME	Guarantee amount based on member contributions High levels of coverage Guarantee funds on deposit
NGO/Non-profit (*e.g.* AGRA, Enablis)	Likely to target specific sectors and social outcomes in line with broader intervention strategies May bundle guarantee with other interventions at firm level Lending terms may be more prescriptive	Likely to require additional reporting on targeted social impact or borrower composition etc.	Fees range, but can be lower or even non-existent Loan coverage likely to be more generous (either high % or first loss arrangements) In some cases funds are deposited with bank
Donor/Bilateral (*e.g.* USAID, AFD)	Likely to emphasize portfolio guarantees, which require less provider administrative work May target sectors (in line with country development strategies) but likely to defer to banks on loan terms	Processes usually standardized across countries and linked with central office Require regular reporting (typically quarterly) Likely to emphasize fast and credible repayment of claims Can provide technical assistance to banks or client	Likely to use a product-based approach across multiple countries Generally lower fees to attract bank participation 50-50 risk sharing common
DFI/Dedicated multi-country (*e.g.* IFC, EIB, AGF, GARI)	May link guarantees to other types funds of investment Within purpose of guarantee, banks have strong control over how it is used Individual guarantees likely to be large in size	Processes likely to emphasize migration of risk Likely to emphasize financial reporting over social indicators May bundle guarantee with bank capacity building	Less-favorable guarantee terms for banks, given need to be financially self-sustaining (unless donors are involved) Generally higher fees Capable of sophisticated and flexible guarantee structuring to meet individual bank needs

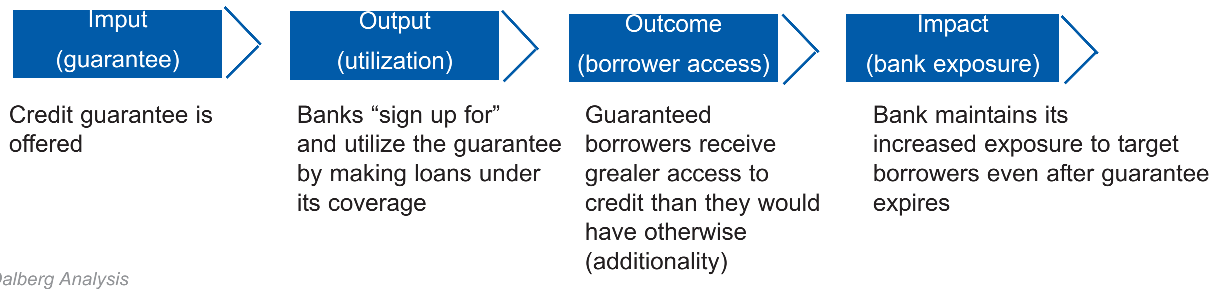
Source : Dalberg Analysis

4. Guarantee Performance and Lessons Learned

4.1. Assessing the performance of credit guarantees

The performance of credit guarantees can be assessed in terms of the primary bank utilization – *i.e.* the amount of bank lending under the guarantee – and the resulting changes in access to finance for SME borrowers. One way to think about this involves a simple logic model, or theory of change, as follows:

Figure 22: Simplified logical framework for assessing credit guarantee performance



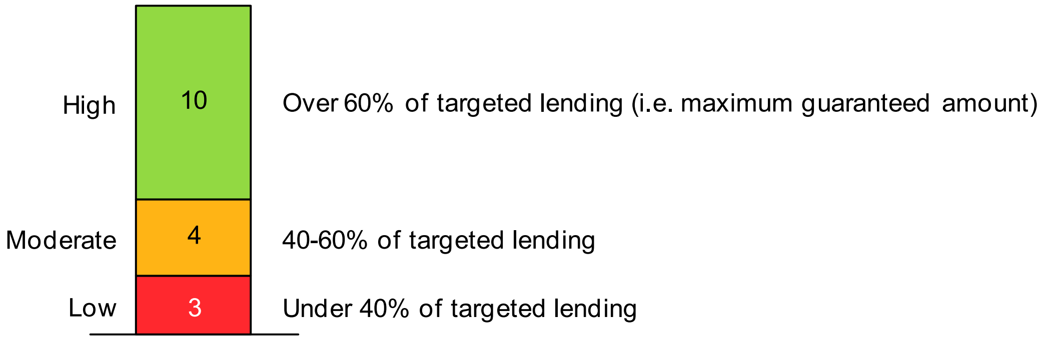
Source : Dalberg Analysis

4.1.1. Output: Utilization

Before discussing outcomes and impacts (borrower access and bank exposure), we first address bank utilization, which is an essential objective of any guarantee scheme. Based on the relatively low level of guaranteed lending in the countries studied, given the size of bank portfolios and potential for a greater supply of guarantees, we may infer that bank "sign-up" and utilization is also a difficult objective to achieve. Even after banks invest time, and often money, in signing a guarantee agreement, a significant number – though not a majority in the available data we found – fail to exceed 60% utilization of the total guarantee available (see figure below).

Figure 23: A significant minority of guarantees fail to exceed 60% of targeted utilization

Utilization rates for portfolio guarantee schemes (# of schemes by category)



17 current and past portfolio schemes in four countries, for which data is available. Data reported in interviews or in program evaluations. Target assumes linear distribution of total lending over guarantee timeframe.

Source : Dalberg Analysis

A simple but important insight that emerges from assessing guarantee performance with banks is that banks make a straightforward – and likely short-term – profitability calculation when determining whether to agree to, and ultimately use, a guarantee. In this calculation, they compare the expected returns from loans to be guaranteed against the expected costs.

On the returns side, there is the expected revenue from the borrowers reached through the scheme. In cases where the bank is already lending to the target sector – which according to the banks is often the case – these revenues will be compared to expected revenue from those same borrowers in the absence of the guarantee. Some banks may factor in expected future revenues from expanding their market share, helping their clients grow, or reaching a new sector. These are ultimately the types of banks that make better partners for CGS providers, but this way of thinking appeared to be the exception rather than the rule among the banks interviewed.

On the costs side, banks look at: (1) financial costs; (2) labor/opportunity costs; (3) the expected default rate; and (4) the expected value of the claim repayment (*i.e.* level of loss mitigation). Observations are as follows:

Financial costs (fees)

A common refrain heard from banks is that "*[a guarantee provider] wanted us to use their guarantee, but their fees were just too high*". In each case, the banks were referring to guarantees with fees in excess of 1.5% of the guaranteed amount annually. Some portfolio guarantees consist of an upfront origination fee on the total guarantee size, combined with a smaller per annum utilization fee on the outstanding guaranteed amount. USAID uses this approach in order to ensure that banks are committed at the outset to using the guarantee, and are unhindered by high fees once they begin to disburse. If a bank fully utilizes such a guarantee, the effective fee level will be quite low in comparison to other schemes. However, a number of recipients complained about this fee structure, because they could not factor origination fees into loan pricing, and they noted that banks are typically already uncertain about market prospects if they are seeking a guarantee. At the same time, we observed generally high utilization of USAID portfolio guarantees in the countries studied.

For individual loan guarantees, banks typically factor the guarantee fees directly into the price of the loan and then ask whether the target customers would be willing to pay for a loan with a 2-3% fee built-in. If the answer is yes, the question then becomes whether it is worth having a guarantee if the bank can command such a high price, or whether the price alone would cover the increased risk. If the price alone would justify the increased risk, then it is possible that the guarantee is not targeting borrowers in sufficient need of intervention. But since guarantees are typically limited when it comes to enforcing borrower targets, this more importantly points to the need to select a guarantee provider already motivated to take new risks.

> *"SMEs are not really price sensitive: access to the money is more important than the cost of it."*
>
> - Representative of a "big four" South African bank

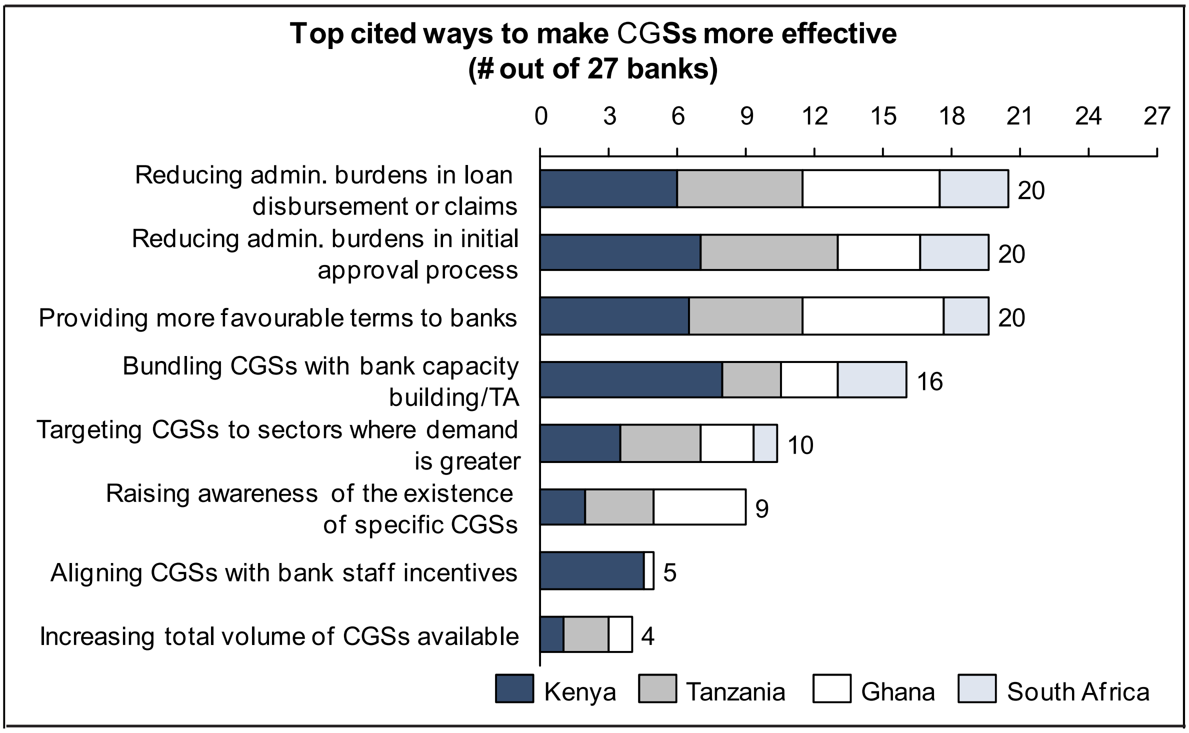
Alternatively, the higher price may make it impossible for the bank to sell guaranteed loans – in which case the cost of CGS administration has completely eclipsed the benefit of the guarantee. In at least one clear case, a bank used a guarantee program to identify potential borrowers, but provided its own lending products in place of the high-priced guaranteed loan. The borrowers (and the bank) did benefit, however, from the SME-capacity building provided by the CGS program. While experts and banks tout SME inelasticity to interest rates, the fact remains that interest rates are a top concern for many SMEs. Guarantee fees are nearly always priced into loans in one form or another, and while risk premiums may be reduced by the guarantee, a bank's (desirable) venturing into a new market may offset this reduction. As such, high fees that reflect CGS provider inefficiencies will ultimately create higher (and possibly prohibitive) costs for SMEs in making use of the guarantee.

Labor/opportunity costs

The number one and two most-cited ways to make credit guarantees more effective, according to banks, both involve reducing the administrative burdens associated with implementing them. Banks bemoan eligibility and renewal-of-eligibility processes that last for months, citing excessive bureaucracy in the due diligence process. Some banks feel that quarterly reporting requirements are too frequent, and dislike having to use separate information systems or report on indicators they do not normally collect. Banks also complain of delays in getting individual loan guarantees approved. And they do not believe they are in the business of SME capacity building (and may resent feeling obligated to provide loan mentorship), even though they do believe that capacity building is key for the bankability of the sector. Lastly, banks especially struggle with lengthy claims procedures that include excessive bureaucratic hurdles before repayment is made (discussed later).

While one might expect banks to complain of *any* new administrative burden, it is important to note that all such requirements on banks will eventually be factored into their perceived cost of using the guarantee, and can prevent them from doing so. In some cases, banks are rejecting guarantees up front based on past experiences or projected administrative costs; in others cases, they may not fully realize these costs until after they sign the agreement; after they do so, they then stop utilizing the guarantee. One solution suggested by banks, and used by some credit-guarantee providers, is for the CGS provider to provide advisory and other support to the bank, such as for training staff, the implementation of new reporting systems, and especially the mentoring of new borrowers. In many cases, there are donor funds available to cover the cost of this support or to share it with the banks.

Figure 24: Reducing administrative burdens is critical to CGS effectiveness



Source : Bank survey results in Ghana, Kenya, South Africa and Tanzania.
(Fractions result from weighting multiple survey responses for the same bank).

Expected default rate

One of the most common frustrations with loan-guarantee programs – and one that remains embedded in the memory of some banks – is the phenomenon of high default rates on guaranteed loans. We found that one-third of the 18 guarantee schemes, for which indications of default rates were available, had moderately high (roughly 10%-20%) or very high (over 20%) default rates. While a majority of the actual schemes in place had default rates of under 10%, banks interviewed often reacted to the topic of guarantee schemes by mentioning a specific scheme that they had attempted (or learned about) where a large number of loans went bad, thus leaving the bank skeptical about similar programs. For example, a Kenyan bank quickly brought up "*the [CGS provider] disaster, where greater than 60% of the businesses defaulted within the first two years*".

> *"When the borrowers smell government, they stop paying."*
>
> – Credit guarantee provider, Ghana

In an agricultural guarantee scheme in Ghana, "*some farmers demonstrated unwillingness to pay, not just inability*".

The frustration is usually not that the targeted borrowers are inherently risky and hence more likely to default. Rather, banks believe that the same guarantee programs create the conditions for higher default rates than if the same borrowers were provided an un-guaranteed loan. The chief cause of this is the way the guarantee is presented to the borrower. According to banks, governments or development organizations eager to tout their social impact can spread the idea that a credit guarantee is their way of helping the disadvantaged. The "disadvantaged", in turn, perceive the loan guarantee as a form of grant and proceed to default in high numbers.

For this reason, one CGS provider encourages banks not to disclose whether a portfolio loan is guaranteed. However, word can still get out *via* loan officers with misaligned incentives, or if a bank wants to pass on the guarantee utilization fee and has a policy of full disclosure regarding fees. In South Africa, regulation appears to require disclosure of a guarantee to customers if any part of the price of the loan is impacted by the guarantee. Instead of concealing the presence of the guarantee, banks can try to ensure that the framing and marketing of the loan product itself is not dominated by the guarantee – *i.e.* not seen as a government or donor-initiated program, but part of the bank's loan offering – so that the guarantee becomes simply a detail of the lending terms rather than a key feature of the loan.

Guarantees can also lead to unnaturally high default rates if they provide higher levels of coverage for a given loan (*e.g.* 75% or greater), which can lead to distortions in the way a bank assesses loans. One banker even noted that he preferred a 50-50 risk share to what might be considered more generous arrangements, because "*this is more of a partnership, and you act like a normal bank and make real assessments*". This idea is consistent with the goal of enabling banks to continue to serve a new market after a guarantee has expired: banks must learn how to assess new types of risk beyond relying on the guarantee.

With certain individual guarantee programs, default rates were significantly higher for some banks than others under the same scheme. This highlights the importance of a bank's attitude and approach to implementing a guarantee.

Even with a more modest 50% guarantee, banks must ensure that loan officers assess loans the same as a non-guaranteed loan, and invest in effective loan monitoring systems. If entering a new sector, especially agriculture, a bank may need to modify existing monitoring approaches, something that should be clear to the bank at the outset. With certain individual guarantee programs, default rates were significantly higher for some banks than others under the same scheme. This highlights the importance of a bank's attitude and approach to implementing a guarantee. Nevertheless, even if high defaults on guaranteed loans can be blamed on the bank, this will still negatively impact banks' overall perception of the value of guarantees.

Expected value of repayment (claims and coverage)

The last component of cost that banks factor into their guarantee-utilization decision is the expected value of claim repayment (a lower value is equivalent to a higher cost for the guarantee). Many of the banks interviewed had not actually made claims on guarantees, for a variety of reasons including not wanting to give borrowers the impression that it is easy for them to write off loans. But those who had made claims stressed the importance of quick and credible repayment (because slow or uncertain repayment is the same as reduced guarantee coverage). A bank in Ghana has foresworn regional credit-guarantee funds after attempting to make a claim on a guarantee (outside the countries studied) and being denied for what it believed were frivolous technicalities. A Kenyan bank spoke of waiting years for repayment, and believed that the solution was having guarantee funds on deposit.

Multi-country guarantee providers have worked hard to streamline their processes to avoid these issues. For example, AFD commits to providing 50% of the guaranteed portion within 2 months of receiving the request from the bank, and the rest at the conclusion of recovery proceedings. USAID pays the full guarantee 30 to 45 days after receiving the bank request, which can come after a loan is 90 days past due. The bank then shares any amount recovered later with USAID. Enablis, a guarantor operating in South Africa, is actively marketing its guarantee as a "quick-payout" product, specifically to address bank fears of not being able to recover funds. In Tanzania, PASS keeps its guarantee funds on deposit with NMB to ensure quick access to claims money.

The expected value of claim repayment is of course most influenced by the amount of coverage offered. All things being equal, almost all banks prefer higher guarantee coverage, but they also generally recognize the need to share risks. Many banks appeared to draw a line, however, with agreements in which the bank was to bear the full first loss, up to a certain threshold, based on typical default ratios. While the logic of this arrangement is that the guarantor bears any *excess* risk, many banks felt that this offered them very little incentive to try something new because there was no upside. Representatives of one DFI that typically offers this type of guarantee believed these terms have significantly limited the number of signed guarantee agreements in Africa – in some cases, the DFI looks to a donor to share the first loss with the bank.

Bank of Tanzania SME CGS illustrates challenges associated with government schemes

In 2004/2005, the Government of Tanzania established the Small and Medium Enterprise Credit Guarantee Scheme (SME-CGS) aimed at supporting SMEs by increasing access to finance. The scheme is managed by the Bank of Tanzania (BoT). Twenty-two commercial banks in Tanzania have signed deals with BoT although only 11 banks are actively using the guarantee. Individual loans worth a total of $7.8 million are currently guaranteed under the scheme. This total reflects full usage of funds currently designated for the guarantee, although it is unclear whether this cap could be raised if demand were greater.

A government guarantee open to all banks provides a chance to sample the range of bank perspectives on guarantees, as well as to assess some of the challenges with government-sponsored guarantees. We interviewed banks that have used the guarantee, banks that signed up but have not used it, and banks that have opted not to sign up at all. The latter two groups provide a window into why banks choose not to utilize guarantees. Concerns expressed include:

Unclear outline of processes and procedures: Administrative processes and claims procedures for the guarantee were not clearly outlined. One problematic clause stated: "*Reimbursements will only be made after the bank has conducted due collection procedures*." Some banks interpreted this to mean the government could decide not to reimburse the bank even years after the default of loans, by claiming that due collection procedures were not used.

Suspicion of government's "heavy hand" in the guarantee: Government guarantee funds are channeled through the country's central bank and the government's involvement in all areas of this guarantee was a cause of suspicion by many banks. Some banks worried that with a regime change the program could end, and their defaulted loans would go unreimbursed, while other banks doubted they would be able to take BoT to court in case of any dispute. Other banks did not trust the government and doubted if the pool of funds had really been set aside for this project, or if this was just a public relations ploy. If the guarantee program had been managed by an independent entity, there might have been more faith in the program. In the coming years, the government does hope to create a separate entity to run the guarantee scheme.

Herd mentality: Some bank representatives mentioned not using the guarantee because they heard that many banks that had signed on were not using it. They felt that if that was the case, then there must have been a good reason for others not using it. Thus, initial low utilization became self-perpetuating.

Moral hazard: The program was highly publicized in Tanzania. Bank representatives recall banking halls being filled to capacity a few days after the announcement of the guarantee. A lot of the SME owners applying for loans were not representing legitimate SMEs, or if they were, quite a number of them were start-ups. This discouraged banks from using the scheme, as they felt that they were now attracting clients that were not creditworthy.

One clear success: a new product for a targeted sector

Despite the program's challenges, there has been at least one clear success. National Microfinance Bank used the guarantee to provide pioneering warehouse-receipting services for cashew farmers in rural Tanzania. The bank's determination to expand into this sector contributed to the large success of the project. Warehouse receipting was a product NMB had little prior experience with, and they credited the guarantee with giving them enough confidence, both to test the product and to expand investment in the cashew sector. Some of the key successes in this scheme include:

Bank getting deep experience in the sector: The bank is now offering loans for a second season of cashew, and did not need to use the guarantee in this second round. The bank was highly pleased with the results of the guarantee in the previous season – there were no defaults – and now has a deep understanding of the sector.

10x growth in the cashew nut lending portfolio: Prior to utilizing the BoT guarantee, NMB had been providing around $3 million in loans to cashew nut farmers. The bank's current lending portfolio to cashew nut farmers is now around $37 million. (Last year cashew exports exceeded $60 million.)

National Microfinance Bank's experience with the GoT SME CGS shares common elements with other successful guarantees, including: a highly committed bank; a new product offering to SMEs; and a clear sector target that motivated the bank to use the guarantee to seize a market opportunity.

4.1.2. Outcome and impact: Access to credit and increased bank exposure

All of these issues relate to the attractiveness of a guarantee to banks. However, bank utilization of a guarantee does not in itself ensure that additional credit is made available, much less that a long-term impact is generated, in the form of permanently-expanded bank exposure to the sector. Real changes in SME access to finance depend on: borrower targeting; adjustments in loan procedures; and long-term changes in banks' perspective, most likely complemented by capacity development aimed at the banks and/or borrowers.

For individual guarantee programs, the CGS provider's administrative costs for assessing loans may put upward pressure on loan sizes. As a result, smaller and perhaps needier borrowers may be excluded due to some of the same forces that lead banks away from the sector. To combat this, the Khula program in South Africa, which is driven by a mission to increase financing for the excluded, counter-intuitively charges higher fees for larger loans in order to incentivize banks to seek guarantees for smaller loans.
For portfolio guarantees, the most effective borrower-targeting approach involves a collaborative effort between the bank and the guarantee provider in order to find areas of strategic alignment. To increase access to finance, guarantees (especially those that are not market-priced) should make banks stretch to reach customers that they would not otherwise reach. However, it is generally not practical (or acceptable to banks) to narrowly define which borrowers will receive loans. Banks highly value flexibility and partnership on the part of guarantee providers. For this reason, it is critical that the guarantee provider and the bank already share a common objective to reach a new segment of the market, before the guarantee is introduced. This segment of the market could be a different size of firm, a new sector, or a new geographic region (as in the case of Root Capital, a non-bank financier already committed to funding SMEs, but initially cautious about moving into East Africa – see box below).

Some guarantees observed successfully enabled banks to reduce collateral requirements or extend loan durations, but others merely provided "comfort" with no changes in loan procedures. As with borrower targeting, the choice of bank makes a difference. Some banks are committed to finding ways to make it easier for SMEs to borrow, or to tailor their offering to better meet SME financing needs, while other banks are happy to have redundant securities and do business as usual.

There are of course tradeoffs between various possible objectives of guarantees – serving a brand new market, lowering interest rates, and easing collateral restrictions may not all be possible at once. However, since CGS providers typically do not want to interfere with bank-lending decisions, it makes sense to work with banks that are already looking to find innovative ways to assess or securitize SME risk, or offer new products and services to SMEs. (The specific approaches of these types of banks have been discussed previously.) These banks are typically also open to collaborating with guarantee providers.

Two banks – two views of guarantees

Conservative	Committed
"Guarantees can provide extra comfort for credit approvers, and may help lengthen tenures for guaranteed loans, but they are not likely to change our policies or approach to the sector."	*"We use guarantees to focus on new products and new sub-sectors…We need guarantees for the first two years, because of the inherent risks. They make us more comfortable and help us build a better understanding of the sectors….Even if guarantee partners pull out, we will still operate [in these sectors]."*

Ultimately, if a guarantee serves only as an input into an otherwise identical lending and credit assessment process, it is unlikely to have any impact after it expires. For true long-term impact, credit guarantees need to catalyze, or at least facilitate, new bank behavior. One philosophy of how to do that is to provide generous guarantee coverage linked to specific (and ambitious) borrower and lending guidelines – as in the case of AGRA's agriculture lending guarantees. This may be effective as long as the experience so significantly changes the bank's understanding of the sector that it feels comfortable continuing without such a safety net. The other approach involves supporting the incremental movement of banks into new areas of lending through equal risk sharing – this works if the bank is already committed to changing the way it does things but needs a chance to experiment in a reduced-risk setting.

USAID DCA guarantee facilitates Root Capital expansion into East Africa
(Summary of independent evaluation findings)

From 2005 to 2008, USAID extended a $2 million DCA portfolio guarantee to Root Capital to help the organization expand its lending model into East Africa, specifically to finance coffee cooperatives in Ethiopia, Kenya, Rwanda, Uganda and Tanzania. Root Capital is a non-profit social investment fund that provides financing and technical assistance to rural producer businesses. Prior to this guarantee, it had focused primarily on Latin America. The guarantee was 80% utilized during the time span. An independent evaluation (USAID, 2010) commissioned by USAID found that the DCA guarantee helped Root Capital expand its operations into new geographies and to sustainably grow its overall portfolio of lending. The guarantee did not cause Root Capital to change the types of loans it offered or the category of clients, because it was already committed to providing working capital to "*rural SMEs selling… products to international buyers through forward purchase contracts in hard currency*". However, the guarantee did enable Root Capital to take bigger and bolder steps in pursuit of its mission, including:

Lending to riskier clients and locations: Through these guarantees, Root Capital provided financing to mostly new customers that would otherwise have had difficulty qualifying for the loan they received. This especially applies to customers in

Ethiopia and Rwanda, where Root Capital faced difficult-to-assess political and regulatory risk. While USAID technical assistance projects helped introduce some of these new clients to Root Capital, the evaluation notes that Root Capital "*would likely not have entered the East African market in the first place without the DCA guarantee*".

Expanding client base and portfolio: Two-thirds of the firms receiving guaranteed loans received at least a second non-guaranteed loan from Root Capital. Additional lending to these firms alone nearly tripled Root Capital's Africa non-guaranteed portfolio, which reached $2.9 million. In other words, the guarantees enabled Root Capital not just to reach riskier clients, but to help them grow and become creditworthy, independently of a guarantee.

Building a deeper understanding of new markets. The DCA guarantee enabled Root Capital to understand the East African Fair Trade/Organic Certified coffee markets in order to better assess risk going forward in the absence of a guarantee. Root Capital has subsequently established a thriving operation in East Africa, and branched out beyond the coffee sector.

Regarding beneficiary impact, the evaluation notes that "*Root Capital intends to work with creditworthy clients until they transition to commercial banks for their credit needs; hence the DCA beneficiaries whom Root Capital retained will likely continue to benefit from the organization's credit offerings*".

This experience of Root Capital, consistent with our own conversations with the organization, illustrates the potential value of working with non-bank financiers of SMEs that are already committed to reaching the sector. These organizations can use a guarantee to take bigger risks, accelerate their growth, and increase their offering to SMEs. Root Capital has recently signed on to a much larger, longer-term DCA guarantee designed to help the organization enter and increase its exposure in a range of countries.

Capacity building

Many experts believe capacity building (targeting banks or SMEs) is an obvious complement to any financial intervention with banks because banks need to change the way they operate and assess risk, and SMEs need to better understand how to manage cash flows and assess financing needs. There is a strong consensus that SMEs must be financed in a way that is distinct from both corporate and retail clients. Many banks accept this fact, but do not know how to execute an SME strategy, especially at all the relevant levels of the organization. At the same time, banks may overestimate their understanding of how to serve SMEs and underestimate the degree of change required to do so. Most of the banks we surveyed believe they have the necessary capacity to serve/expand in the SME market, but this view is not consistent with the perspective of SMEs, or with the number of banks actively employing established best-practices for serving this sector (IFC, 2009). For these reasons, many guarantee funds bundle bank capacity building with guarantees, and some may even view the guarantee as a vehicle through which to channel technical assistance. For those banks needing a change in perspective, the provision of advisory services to help bring this about – *e.g.* the assignment of a long-term consultant – is more likely to ensure the success of a guarantee scheme than the guarantee alone.

Capacity building at SMEs is also critical to increasing their access to finance, but not as simple to incorporate into a credit guarantee scheme. Previous Dalberg analysis of SME capacity building projects in 31 countries in Africa found that SME-capacity building was likely to be more successful when bundled with access-to-finance interventions, such as bank loans. Conversely, increased financial understanding and communication by SMEs is certainly likely to improve their chances of obtaining loans. Banks in all the countries studied see issues such as financial management and corporate governance as major challenges to SMEs' ability to obtain necessary capital. But this is particularly true in South Africa, where the financial system is relatively more advanced than the SME sector, especially the SMEs typically targeted by guarantee programs – *e.g.* small firms headed by individuals previously disadvantaged under apartheid.

> "*We can provide guaranteed loans for [small and previously disadvantaged enterprises] but who will help them register for VAT, negotiate with their supply chains, etc. There is a need for TA to reach these SMEs.*"
>
> Representative of a "big four" bank in South Africa

Banks see a limit to their ability to "mentor" or "handhold" new SMEs reached through a guarantee program, tasks they believe should be the responsibility of the types of development-focused organizations that are offering guarantees. The challenges to be overcome in bundling SME-capacity building with credit guarantees are: (1) ensuring that SMEs do not see the loan as a form of donor assistance; and (2) banks learning to assess SME risk, rather than relying on donor engagement as a proxy for creditworthiness. One possible solution could be to provide *ex post* capacity building to SMEs, *i.e.* after the loan has been signed. This would not address an individual SME's ability to apply for financing, but it could reduce defaults and lower banks' risk perception, without altering the individual loan-approval process.

IFC Schools program integrates credit guarantees with bank and SME capacity building

The IFC Schools programs have been innovative in developing an integrated approach to strengthening a very specific sector. Credit guarantee agreements have played a key role in financing the private schools (which are the SMEs) targeted by the program.
In 2005, IFC signed its first agreement with TTB in Ghana, which has since been extended twice (in 2007 and 2009) to cover a targeted $15 million in guaranteed lending for schools in Ghana. The guarantee is a second-loss agreement whereby IFC provides 50% loss sharing after the first 5% of losses. The bank has been eager to implement the guarantee, and utilization has reached 74%. In 2006, IFC signed a similar $2.8 million, 3-year guarantee agreement with K-Rep bank in Kenya. This guarantee was a 63% risk- sharing agreement on the second loss after a 5% first loss has been absorbed by the bank.

These two programs are notable because they were integrated with a comprehensive set of advisory services, including IFC training of banks for them to understand the education sector and assess credit applications, and ongoing advisory support to schools on the business and cash flow aspects of managing their operations. In Kenya, around 130 schools received capacity building on issues in corporate governance, HR policies, financing, etc. IFC anticipated that many of these schools would become borrowers from K-Rep or other banks after signing on to the program and getting training. As of 2008, K-Rep had made out loans to 33 schools. The loans are customized well for schools, and loan repayments are made in three annual installments tied to school cash flow (school fees collected at the beginning of the term).

In Ghana, the program has provided more intensive support to a set of 25 schools. Evaluations have found that the program has led to increased student enrolment, improved management systems, improved education delivery, and greater access to finance. TTB has grown its education-sector loan portfolio through the guarantee, and now offers education-sector loans with durations of 3 to 5 years as opposed to 6 to 12 months prior to the program.

A key aspect of the success of these programs appears to be the close partnership developed between IFC and the individual banks in Ghana and Kenya. By enabling one (relatively small and specialized) bank in each country to make this sub-sector a priority niche lending area, IFC was able to secure the necessary commitment to internal capacity building and to actively work to finance the schools in the program.

4.1.3. Strengths and weaknesses of common CGS models

The table below highlights a number of strengths and weaknesses of some of the most common guarantee scheme models, in terms of both utilization and SME outcomes/impact:

Table 5: Strengths and weaknesses of common CGS models

CGS model	Strengths	Weaknesses
Small individual loan scheme	Lower reporting burden for bank after utilization Easier to enforce lending criteria More likely to reach excluded borrowers Can be easily linked to SME capacity building	Duplication of loan approval processes leads to greater effort, slower utilization and higher fees/transaction costs High visibility of guarantee provider (and typically high coverage rates) may encourage default Does not encourage banks to think in terms of portfolio strategies or new lending models; may just serve as exogenous collateral for individual SMEs
Large individual loan scheme	Lower relative transaction costs May serve to introduce banks to providers of portfolio guarantees Faster eligibility requirements	Likely to reach a smaller number of higher-end SMEs Not likely to facilitate an overall change in bank behavior, or strategic shift Duplication of loan approval processes leads to slower utilization and higher fees/transaction costs
Shared loss portfolio scheme	Encourages banks to think in terms of expanding their portfolio to include new market segments Banks have "skin in the game" so they are more likely to adopt sustainable lending approaches Typically flexible to bank priorities Easy to link with bank capacity building Lower fees/transaction costs	Incentives not strong enough to require radical change within banks Lengthy up front eligibility processes Higher reporting requirements
First-loss portfolio scheme	More attractive to many banks May be able to impose stronger conditions on target borrowers, lending approaches Can catalyze more radical changes within banks if conditions are right Can be highly-leveraged Easy to link with bank capacity building Lower fees/transaction costs	Generous coverage may promote moral hazard by banks and/or borrowers Conditions and provisions of guarantee may create artificial setting that does not help bank transition to non-guaranteed lending in the same area Lengthy up front eligibility processes Higher reporting requirements

Source : Dalberg Analysis

4.2. Broader lessons on effective credit guarantees

The list below highlights some of the most important lessons from the findings presented above. It is purposely concise to provide an action-oriented distillation of the key implications for credit-guarantee providers:

1. Be clear (and realistic) about the desired outcome

A guarantee will not change the strategic direction of a bank and is unlikely to introduce new operating procedures on its own. Rather guarantees may:

- Increase the volume of existing lending during the lifespan of the guarantee;
- Accelerate ventures into new markets or segments that the bank is already committed to exploring;[11]
- Test new lending approaches the bank is already interested in.

2. Understand tradeoffs in guarantee design

- There is a tradeoff between access to finance and the cost of finance – forcing banks to reduce interest rates to a new customer segment counteracts the incentive to take greater risks.
- There is also a tradeoff between the market orientation of guarantees and bank experimenta-

[11] Broad sectors like agriculture provide the prospect of a very large market, while niche segments like school loans can offer an opportunity to develop a competitive advantage.

tion. Purely market-priced guarantees can get banks to do more of the same, but concessions may be needed to encourage entry into new and uncertain markets.

- Similarly, there is a tradeoff between the flexibility of guarantee terms and the level of coverage. If coverage is limited (*e.g.* 50-50 risk sharing), banks require more flexibility in their lending under the guarantee; but if coverage is more generous (*e.g.* first loss), CGS providers can be more rigid in their demands.

3. Select the right partners

- Bank commitment to utilizing the guarantee must stem from strategic alignment of interests that leads to engagement at all levels of the organization.
- It is important to also act like a partner – banks do not want to be left alone after the guarantee is signed, and would especially appreciate input from the guarantee provider (through its staff or a consultant) to support implementation of the guarantee, mentoring SMEs, data collection and reporting, etc.
- When banks are not strategically aligned with the guarantee objectives, guarantees may be more effective if provided through investment funds and non-bank financial institutions.

4. Do not overlook the importance of working capital

There is explicit and implicit demand from banks and SMEs for guarantees that enable banks to experiment with new types of working capital finance, enabled through non-traditional securitization (*e.g.* invoice discounting, supply chain finance).

5. Consider the complementary role of capacity building

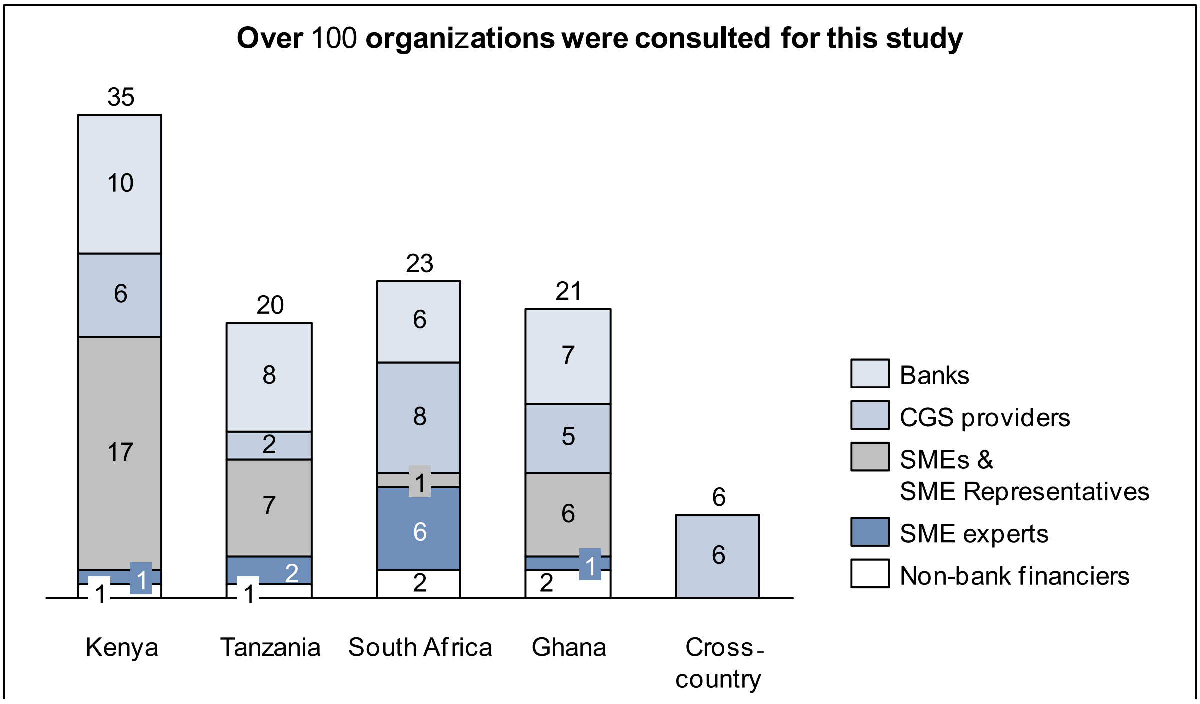
- Banks believe SME management-capacity building is critical to guarantee success and overall increased SME lending, as long as capacity building efforts do not create the perception of the bank loan as a handout, or require excessive additional investment by the bank.
- Bank capacity building can help lower bank costs for using the guarantee, support the development of new SME products, or facilitate critical operational changes in approaching the SME market.

Appendix I: Methodology

Data sources and collection

Our study has relied heavily on interviews, focus groups, and surveys of stakeholders – SMEs, business associations (SME representatives), experts, banks and CGS providers – with reference to CGS and bank documentation, existing studies that reach a larger scale, and others that provide evaluations of specific CGS programs. Interaction with a diverse set of actors on the ground provides a range of perspectives, shedding light on the study questions from multiple angles. In Kenya, we surveyed or interviewed stakeholders from over 30 organizations, and in each of the other 3 countries we have talked to around 20 distinct organizations.

Number of organizations consulted for this study



Organizations provided input primarily during interviews and focus groups; a small minority only filled out surveys. Country offices of global organizations are considered distinct organizations, where consulted separately.

Source : Dalberg Analysis

In all the four countries combined, close to 135 individuals were interviewed or surveyed, representing around 100 distinct organizations.

Interviews and SME Focus Groups

Interviews were conducted in all four countries with the aim of getting perspectives on SME financing and credit guarantees from banks, CGS providers, SME experts, SMEs[12] and SME representatives. Customized interview guides were created for each group, and these were used to guide the conversations with the various stakeholders. The banks chosen to be interviewed were targeted in particular because they collectively cover all the options in the following set of criteria:

- Size of bank: banks with large market shares *versus* small, niche banks;
- Level of SME sophistication: banks that are considered "SME banks" *versus* banks that are typically viewed as "corporate banks";
- Experience with guarantees: banks that have already used guarantees *versus* banks that have not yet used them.

CGS providers were interviewed to find out about their particular experiences with guarantees in the countries of study. However, some guarantee providers were also interviewed on a global level to understand their experience working with and designing guarantees, with the aim of comparing and contrasting this with their experiences in our countries of study. Some of these providers include USAID, IFC, and the forthcoming Africa Guarantee Fund (AGF).

SME experts were consulted in each country to get a good macro-level understanding of the issues faced by businesses in general, and SMEs in particular. SMEs were also interviewed in each country (except South Africa) both individually and in focus groups, to understand the challenges they were facing including those related to access to finance. SME focus groups were conducted with groups of 5 to 15 SMEs and SME representatives, and were particularly helpful in bringing out some overall issues, such as general challenges in accessing finance, types of products needed and experiences with banks. South Africa was a unique case as there was already a lot of information available from previous studies on SME access to finance. Given that, time in South Africa was spent focusing more on other stakeholders.

Surveys

Existing data are scarce in the countries studied, as is the infrastructure for large-scale data gathering (including registries of firms and channels for remote survey administration). In addition, the broad scope and geographic coverage of the study means that qualitative methods are sometimes more suitable in representing the range of perspectives required. Nevertheless, we developed and administered surveys to the main stakeholders, which enabled us to quantify the perspectives we were gathering. While we make no claim to representative sampling, these surveys enable more rigorous analysis of the results of our interviews. They also provide a "sanity test" of individual stakeholder perspectives and of whether results from studies in other countries can be generalized to Ghana, Kenya, South Africa and Tanzania.

Surveys were made for each type of stakeholder. There were four different types of surveys:

- Bank survey
- CGS Providers and SME Experts survey
- SME survey
- SME Representatives survey

Interviews were accompanied by surveys, but surveys were also distributed electronically to SMEs through the Aspen Network of Development Entrepreneurs (ANDE), the African Management Services Company (AMSCO) and Technoserve. ANDE is a global member organization for companies that offer finance or advisory services to small and growing businesses. In all, we surveyed:

- 31 SMEs and SME representatives
- 27 distinct banks
- 9 distinct CGS provider organizations
- 8 SME experts

12 As discussed previously, we did not survey or focus group individual SMEs in South Africa because the available data on SMEs there was of greater quality and relevance than in the other countries, where even our limited sample sizes could yield useful insights. We focused to a greater degree on organizations investing or supporting SMEs in the country.

Document and literature review

Although existing data on credit-guarantee schemes in Africa were generally scarce, we made use of available literature on SME financing and on credit-guarantee schemes during our study (see References section for a selection of relevant literature). We also consulted regional studies on the challenges faced in accessing finance, as well as banking sector country studies. Additional documentation and data sources included:

- Internal and external bank documents, including annual reports;
- CGS provider documents, including brochures, presentations and annual reports;
- Specific guarantee agreement documentation;
- Bank and donor press releases;
- Financial services data compiled in reports by the Financial Sector Deepening (FSD) in Kenya and the Financial Sector Deepening Trust in Tanzania;
- World Bank investment climate surveys.

Investigative approach

In preparation for the study, and the design of our data-collection materials, we developed a table highlighting potential issues relating to banks, SMEs and CGS providers regarding the effective utilization of guarantee offerings. We then created a set of initial hypothesis trees, and developed surveys and interview guides to address all branches of the trees. Having conducted a few interviews and a literature review, the hypothesis tree was refined to focus heavily on the branches of the tree that were being validated by the data on the ground. This is how some questions were prioritized over others. With subsequent interviews, the surveys were appropriately modified. When all data had been collected and tabulated, we referred back to the hypothesis tree to see which branches had been validated.

Hypothesis tree

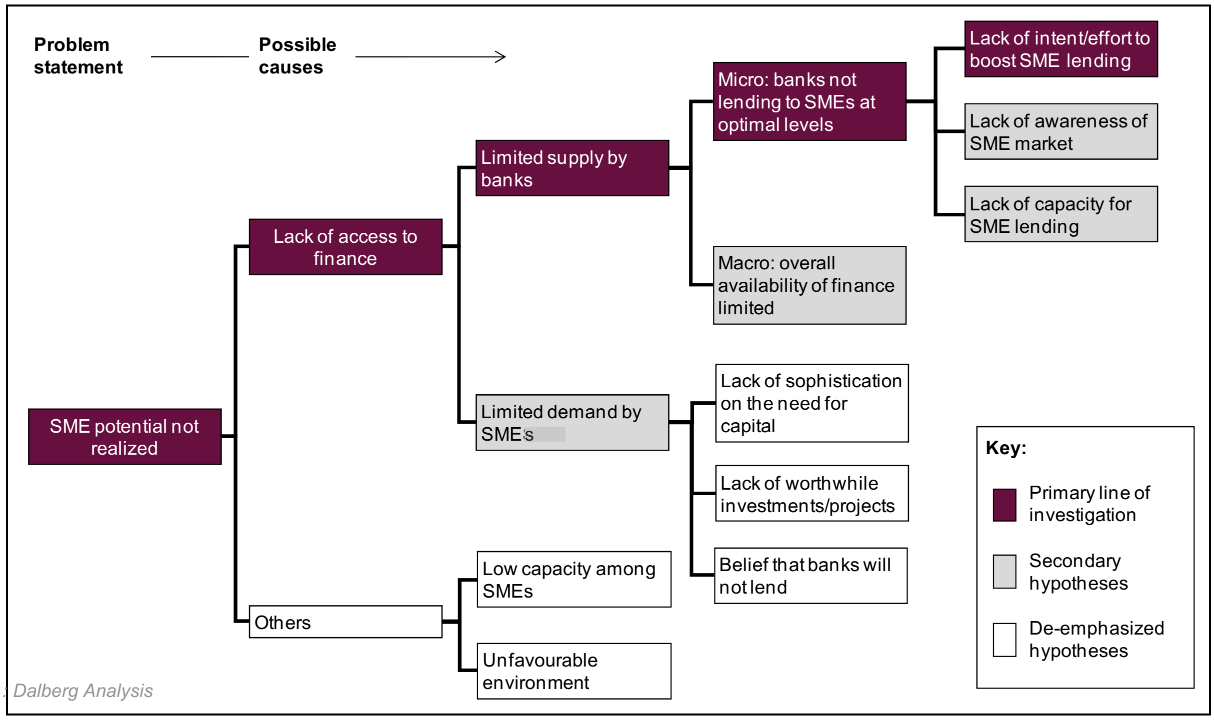
To enforce rigor, we developed a set of hypothesis or logic trees to guide the design of our interview guides and questionnaires, and inform our overall analysis approach. These trees are based on the main study questions:

- What are the main constraints to SME growth? (shallow emphasis);
- How well are SME needs for financing being met?
- What prevents banks from increasing lending to SMEs?
- Under what conditions is a CGS more or less effective as a tool to boost SME lending?
- What is the extent of the mismatch between current CGS offerings and demand by banks?

Ultimately, answering these questions should provide additional perspective on how better to design and implement credit-guarantee schemes that result in sustainable changes in bank lending behavior and greater SME access to finance. Our interview questions, surveys and secondary research were designed to provide perspectives on each of the questions represented by the options on our set of hypothesis trees.

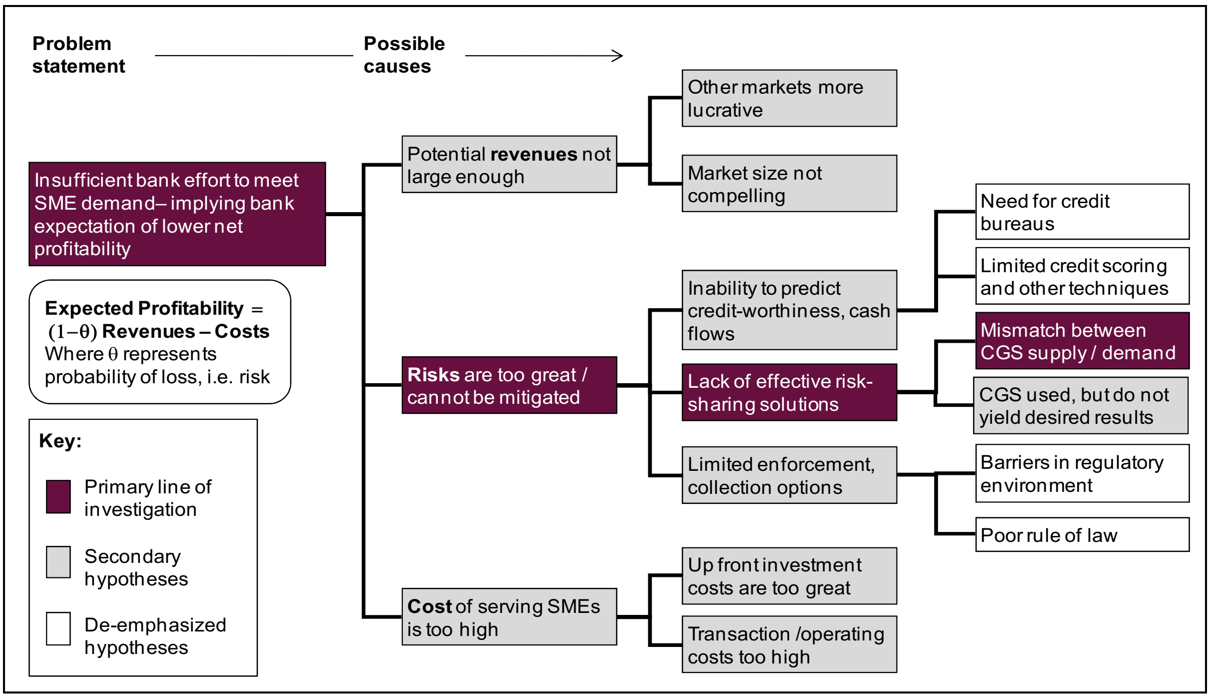
Below we provide the initial hypothesis trees used in the study. In some cases, we had one primary line of investigation that led us to study credit guarantee schemes, but we still tested whether other factors were more or less significant in their contribution to the observed issue. This is color coded in the first two trees.

Hypothesis tree 1: Diagnosing causes of unfulfilled SME potential



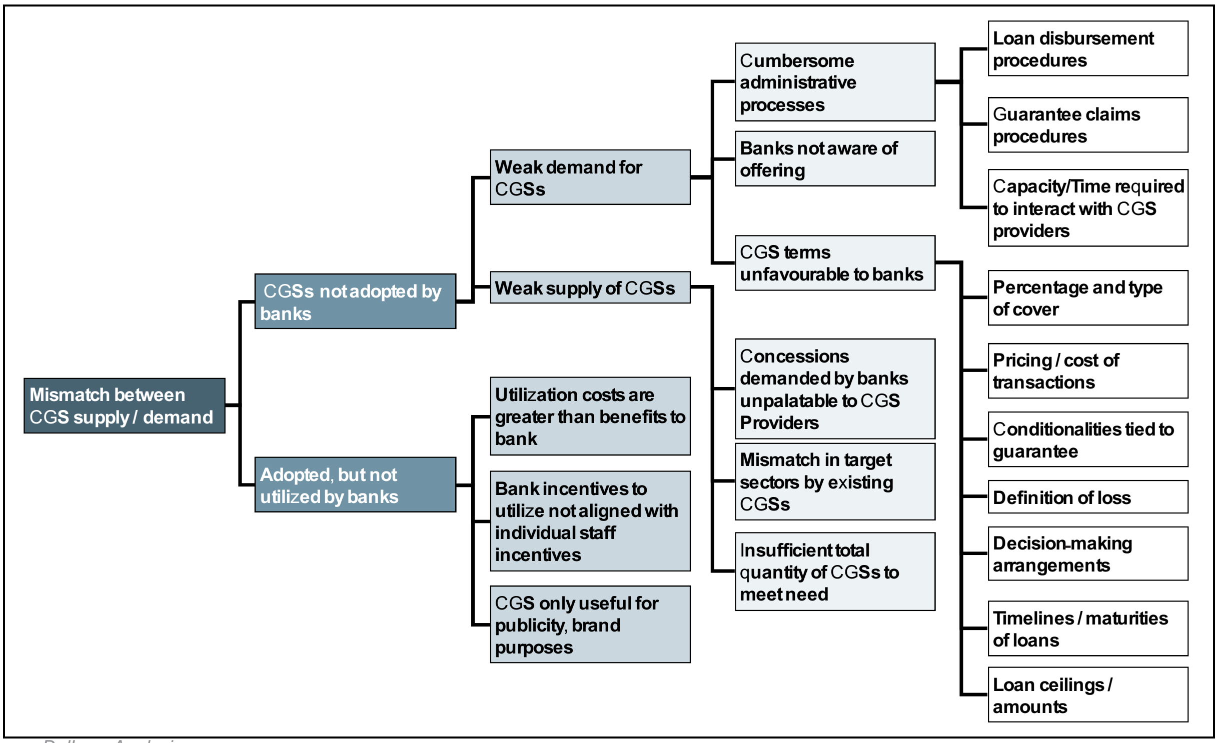
Source : Dalberg Analysis

Hypothesis tree 2: Diagnosing reasons for insufficient bank effort in meeting SME demand



Source : Dalberg Analysis

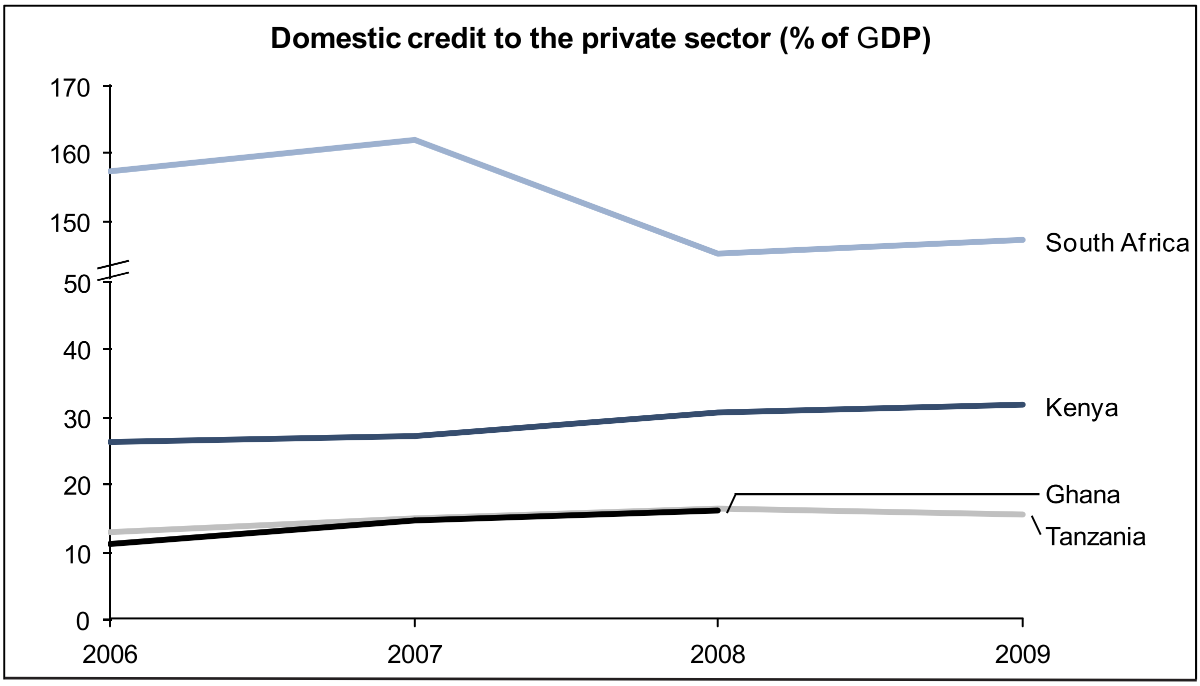
Hypothesis tree 3: Diagnosing causes of mismatch between CGS supply and demand



Source : Dalberg Analysis

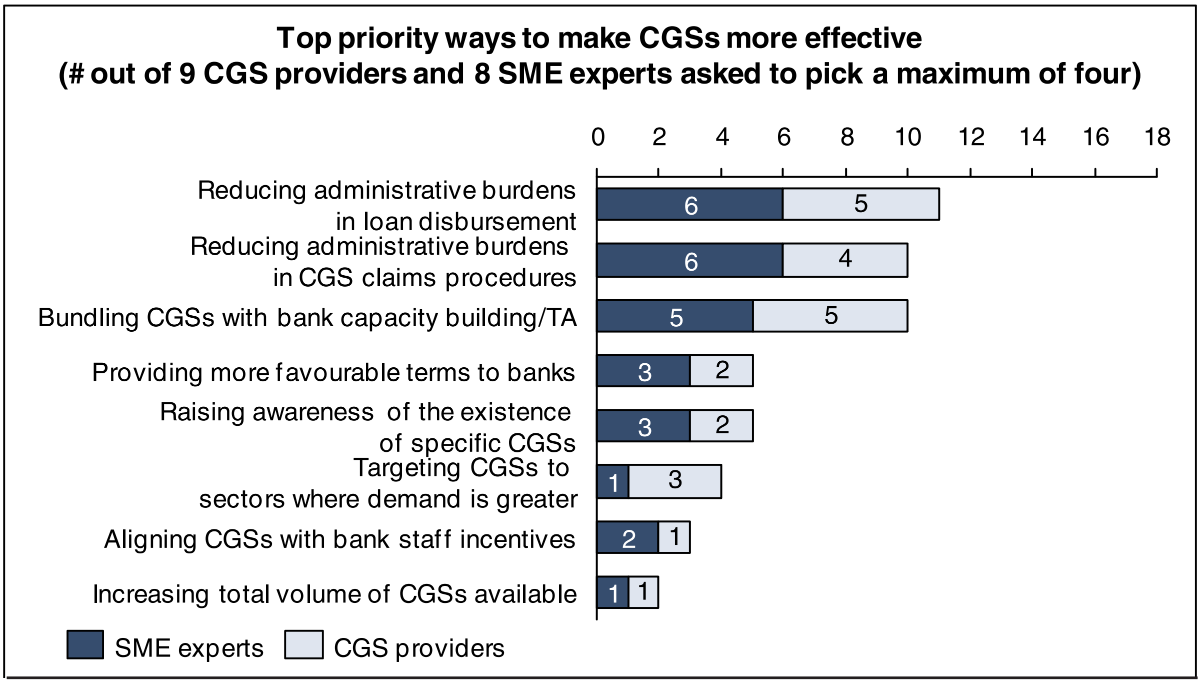
Appendix II: Additional Graphs

Domestic credit to the private sector illustrates the widely different levels of financial system sophistication among the four countries



Source : World Development Indicators.

CGS providers and SME experts generally concurred with banks on how to improve guarantees



Source : Stakeholder survey results in Ghana, Kenya, South Africa and Tanzania

Acronyms

AFD	*Agence Française de Développement*
AGF	African Guarantee Fund
AGRA	Alliance for a Green Revolution in Africa
AMSCO	African Management Services Company
ANDE	Aspen Network of Development Entrepreneurs
BEE	Black Economic Empowerment
CGS	Credit Guarantee Scheme
DCA	Development Credit Authority
DFI	Development Finance Institution
DFID	UK Department for International Development
EIB	European Investment Bank
FABCOS	Foundation for African Business and Consumer Services
FMO	*Financieringsmaatschappij voor Ontwikkelingslanden N.V.* (Netherlands Development Finance Company)
FSDT	Financial Sector Deepening Trust
GARI	*Garantie des Investissements en Afrique de l'Ouest*
GOWE	Growth-Oriented Women's Enterprise
IFAD	International Fund for Agriculture Development
IFC	International Finance Corporation
ILO	International Labor Organization
MCC	Millennium Challenge Corporation
MCGS	Mutualist Credit Guarantee Scheme
MFI	Microfinance Institution
NGO	Non-Government Organization
OECD	Organization for Economic Cooperation and Development
PASS	Private Agriculture Sector Support
SAGF	Sustainable Agriculture Guarantee Fund
SME	Small or Medium Enterprise
SMME	Small, Micro, or Medium Enterprise
TA	Technical Assistance
USAID	United States Agency for International Development

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