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Agriculture Finance Support Facility

TECHNICAL SUMMARY

Credit Guarantee Schemes for Agricultural Development

by Nina Holle. Working paper, 2017

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Introduction

Financial institutions are often reluctant to lend to agribusinesses and farmers because of the risks inherent in financing agricultural production. Credit guarantees are an instrument that can help in mitigating lending risks – thereby leveraging and mobilizing additional commercial financing for agriculture.

This brief provides an overview of credit guarantee mechanisms, focusing on schemes that help expand agricultural finance – usually with a government or international donor bearing some downside risk by assuming debt obligations in the event of default. It describes what credit guarantees are, how they work, and showcases examples of how credit guarantees can help provide finance for farmers and agribusinesses in developing countries.

What are credit guarantee schemes and how do they work?

The need for investment in agriculture is increasing due to population growth and the changing dietary preferences of an emerging middle class. According to estimates, demand for food will increase by 70% by 2050, requiring at least USD 80 billion of additional financing annually. This will need to come from the private sector, presenting both a challenge and an opportunity to the banking sector.

Financial institutions in developing countries lend a smaller share of their loan portfolios to agriculture compared to the sector's share of GDP. Lack of access to finance is often cited as a key concern for farmers and agribusinesses.

Even when financing is available, lending is often informal and short-term, impeding longer-term investments and failing to meet the specific requirements of farmers and small agribusinesses fully and often coming at high cost.

Guarantees (full or partial) represent a promise of complete and timely debt service payment up to a predetermined amount.

Payment is usually guaranteed regardless of the cause of default. The guarantee amount may vary over the transaction lifetime based on the expected cash flows and creditors' stability related concerns.

Effective guarantees are structured to reduce the probability of default, increase recovery in the event of default, and offer the minimum amount of guarantee necessary to facilitate a successful transaction.

A credit guarantee simply substitutes part of the collateral required from a borrower. If the borrower fails to repay, the lender can resort to partial repayment from the guarantor.

An agricultural loan guarantee usually includes three actors:

- The **lender** can be any type of financial service provider, or a participant in an agricultural value chain (often as a buyer and/or seller of agricultural produce and commodities)
- The **borrower** can be farmers involved in production and agribusiness involved in production and/or other value chain activities
- The **guarantor** can be a separate company or other distinct legal entity, or part of a multi-purpose service set-up, usually provided by the public sector or development projects.

Guarantees are a ‘blended finance’ tool that allow efficient use of scarce public resources to crowd in private capital. In this case, guarantees enable financiers to provide lending to agricultural borrowers that may otherwise not be provided.

Typically, credit guarantees cover lenders against payment defaults by a borrower. Although similar to insurance, a key difference is the payment trigger – for loan guarantees payment is triggered by non-repayment of the underlying loan.

Guarantee schemes make lending possible (or more attractive) by sharing risks. Public guarantee schemes aim to catalyze lending to priority sectors or classes of borrowers, such as SMEs, smallholder farmers, or ‘green’ investments. They can act as a substitute for collateral which borrowers would have otherwise needed in order to access commercial lending and expand available credit.

Credit guarantees operate at different levels, top levels usually take the form of investment guarantees rather than loan guarantees. Microfinance investment funds, for example, offer investment guarantees on MFI or SME loan portfolios.

Terms and conditions vary depending on context and partners, and are specified in the guarantee contract. Key elements include the extent of loss coverage, the types of risks covered, the financial instruments covered, and the guarantee fee.

The extent of loss coverage may be for the full amount of any potential loss (unlimited) or partial (limited). Partial credit guarantees cover a specified portion of the debt service, regardless of cause. Full credit (or ‘wrap’) guarantees cover timely payment of scheduled principal and interest to creditors for the entire obligation in the event of default. Their primary use is to achieve a higher credit rating on bonds to lower borrowing costs and/or meet the investment requirements of capital market investors. Otherwise, unlimited guarantees from public entities are rare, as they tend to create perverse incentives.

Risk coverage may cover all risks – protecting lenders against default regardless of cause. Alternatively, they may cover partial risk – covering defaults arising from specified events such as nonpayment under an offtake contract (e.g. agricultural forward sale agreement). Guarantees may cover a range of risks including commercial risk (risk of default on debt service payment obligations) and political risk (risk of losses caused by failure of government to meet specific performance obligations, such as change of laws and regulations, expropriation, nonconvertibility and transferability of currency, war, and civil disturbance). The risk coverage or amount guaranteed is critical. When set too low, banks will not find it practical or attractive to use, and hence new lending will not flow. If set too high, banks will not be motivated to conduct sufficient robust credit risk assessment/due diligence or to spend the time and effort in ensuring prompt debt collection.

Financial instruments covered can range from individual loans (e.g. specific loans) to a portfolio of loans (e.g. a bank’s credit facility for agricultural SMEs or farmer loans). Guarantees have been used to encourage banks to ‘downscale’ into microfinance or small business lending, by providing partial guarantees for credit provided to targeted groups. An agency wishing to see new loans made to smallholder farmers may provide a portfolio guarantee facility that provides guarantees only to small loans made to individual smallholder farmers.

The **guarantee fee** is levied by the guarantee fund manager, and participating lenders usually pass this cost on to the end borrower. The basis of the fee varies as it can be onetime or annual, or a blend of both; a percentage of the underlying loan amount; and/or a percentage of the guaranteed portion of the loan. Some public guarantee schemes offer preferential or concessional terms for targeted classes of borrowers.

Who provides guarantees?

Because of their scale, guarantee schemes are usually provided by government or donor agencies. Private institutions issue guarantees in some instances as well.

Donors. Since the 1980s, guarantees have become widely used as a development cooperation instrument. Multilateral development banks (MDBs) may offer guarantee schemes to developing countries. Their high credit rating and low risk-weighting under international capital adequacy rules enable delivery of highly-rated guarantees at low cost. Bilateral development banks and foundations also engage in guarantees.

Governments. Developing countries have also established their own domestic guarantee schemes, traditionally in the agriculture sector. For example, Nigeria offers credit guarantees for agriculture and Small and Medium Enterprises (SMEs), e.g. the Nigeria Agricultural Credit Guarantee Scheme Fund (ACGSF) and the Nigeria IncentiveBased Risk Sharing System for Agricultural Lending (NIRSAL). The ACGSF guarantees credit facilities extended to farmers by banks up to 75% of the amount in default net of recoveries.

Private. Of the 23 largest microfinance investment funds (MIVs), three offer investment guarantees on MFI or SME loan portfolios. The Dutch Hivos-Triodos Foundation offers 8% of its total MFI investment funds as guarantees. The share is slightly smaller for the innovative Oikocredit investments (also Dutch) and the Solidarité Internationale pour le Développement et l'Investissements.

Types of guarantees

There are two broad categories of credit guarantees based on risk sharing:

- **Pari passu.** The scheme assumes a fixed share of the loss, irrespective of its size.
- **First loss.** The burden from defaults is fully assumed up to a predetermined amount, above which the guarantee scheme has no further obligation.

Guarantees can be further divided into four types:

a) **Individual guarantees for loans.** These guarantees provide partial coverage for the underlying principal loan amount, with both parties to the transaction – borrower and lender – clearly identified. Banks and specialized financial institutions sometimes provide guarantees to individual final borrowers. However, most small commodity producers and agribusiness SMEs are unaware of the existence or functioning of individual credit guarantees.

b) **Portfolio guarantees.** Lending to a specified priority development sector is supported by providing a partial guarantee for a number of loans – one lender with many borrowers.

c) **Guarantee on an investment facility.** Some guarantee agencies offer a variation of the standard model for partially guaranteeing a bond issue. This type of guarantee is useful when a developing economy already has functioning capital markets in place, and medium- to long-term placements of investment funds are needed. Ultimately it results in a lengthening of assets as placements in the money market, helping to deepen and stabilize emerging capital markets.

d) Portable guarantees. These guarantees involve a specific and identified borrower who can compare competing loan terms and offers from various lenders. Borrowers become more attractive and, through the guarantee, have enhanced opportunities to create a relationship with lending institutions. The main advantage is the ability to link the guarantee process with specific results. However, it is not common in development finance, and has comparatively high transaction costs for borrowers and lenders alike (when lenders are dealing with a new and unknown applicant).

Challenges and opportunities

When considering how to improve access to finance for farmers and small agribusinesses, lenders are often more likely to opt for guarantees over other financial instruments.

Guarantees provide the following benefits:

- Banks can meet the financing needs of SMEs without having to take excessive credit risks
- Reducing the expense of handling collateral lowers administrative costs
- Financial service providers develop technical experience and knowledge about the requirements of new client groups
- Development finance resources are leveraged by unlocking excess liquidity in the domestic banking sector.

Dozens of innovations in guarantee services have continued to strengthen the case for such schemes:

- **General institutional, product, or process innovations in the financial sector,** which have a bearing on the functioning of credit guarantees. These include increased automation of rural banks (connectivity and automated core banking solutions reaching remoter parts of the world) and a larger global coverage of credit bureaus.
- **Specific innovations in the design and implementation of guarantee funds.** These include institutional upgrading and an increasing tendency for national and stand-alone facilities; professional management of program funds, without specified sunset clauses and with no or limited scope for political interference; and the direct investment of funds as cash in deposits at partner financial institutions in developing economies, without involvement of international banking intermediaries. Together with the useful separation of individual loan guarantees (mainly for larger and longer-term loans) from portfolio coverage (for smaller loans of shorter duration and where MIS are insufficiently developed to follow each borrower individually), development finance has imported more complex arrangements from corporate banking, such as portable guarantees and bond guarantees.

Nevertheless, guarantee schemes are not without their critics. The most common challenges include:

- Moral hazard. The existence of guarantee systems reduces willingness of end borrowers to service their loan obligations.
- Market distortion. Farm and business development is not left to market forces. Free market proponents consider CGS a hidden interest rate subsidy to SMEs used for political purposes, not a true component of a market economy
- Stakeholders in a guarantee system may have unrealistic expectations such as improved borrower credit culture with greater willingness and ability to repay, lower processing and appraisal costs for participating banks, etc.
- Guarantee funds may lose money through inadequate supervision of banks and screening of final borrowers.

Case studies

Equity Bank, Kenya

Equity Bank is a large African bank, with 5.7 million accounts. It provides over 57% of all bank accounts in Kenya and also has operations in Uganda and Southern Sudan. Established in 1984, it has evolved from a building society and microfinance institution to an all-inclusive commercial bank listed on the Nairobi Stock Exchange and Uganda Securities Exchange.

Equity Bank's approach to agricultural financing is based on direct smallholder lending integrated into a larger supply chain partnership supported by a first loss guarantee provided by donors. Equity Bank has signed a partnership with AGRA (Bill & Melinda Gates Foundation), IFAD, and the Government of Kenya in May 2008. The deal includes a loan project of USD 50 million in agricultural SME loans for farmers with little or no collateral. AGRA and IFAD provide a 10% first loss guarantee (USD 5 million), partially reducing risk of lending by Equity Bank.

Under this arrangement, Equity Bank developed 'Kilimo Biashara', a small-holder financing product designed to make funding available and affordable for 2.5 million farmers and 15,000 agricultural value chain members such as rural input shops, fertilizers and seed wholesalers and importers, grain traders, and food processors in outlying areas.

Through this partnership, farmers have received loans, enabling them to purchase quality seeds and other farm inputs. Farmers have also benefited from access to agricultural expertise and crop husbandry resulting in increased yield and sustenance of livelihoods.

Equity Bank enhances security by:

- Capping loan exposure at USD 17,000 per farmer
- Applying group lending terms, whereby small groups of farmers act as co-guarantors
- Reducing the cash amounts in farmers' hands – farmers can pay agro-dealers out of their Kilimo Biashara credit.

By June 2008, USD 18.75 million in loans had been disbursed, reaching 37,000 beneficiaries. The loans carry a 12% interest rate applied when they fall due — well below the bank's standard rate of 18%. According to Equity Bank, the project has changed the position of smallholders from food insecure to semi-commercial producers.

One of the key success factors is the technical assistance on financial literacy and farm management provided by the government extension service bureau. Repayment risk is mitigated by integration into supply chains, including WFP's P4P program.

USAID, Development Credit Authority (DCA)

Using credit guarantees, USAID provides credit for any development purpose specified by the Foreign Assistance Act. Partial guarantees cover up to 50% of risk lending to projects that advance USAID objectives of catalyzing the private sector in developing countries. USAID missions are the primary contact for obtaining loans, and the Development Credit Authority (DCA) – part of USAID Head Office in Washington, DC – provides authority to issue loan guarantees to private lenders.

From 1999-2015, DCA issued 40 guarantees and mobilized USD 4.2 billion with 343 financial partners in 74 countries. The average default rate was 2.4%. In 2015, USD 393 million was invested in agriculture – 54% of DCA's portfolio.

This model – a centrally managed facility that guarantees specific types of loan granted by private banks – has proven resilient, operating for more than a decade. It leverages domestic liquidity with different types of guarantees that support different sectors and development purposes.

DCA does not have separate corporate status, instead it operates as a form of financing or financial leverage account and involves the USAID field offices. This makes comparison with other funds and assessment of its viability difficult, considering the different levels of credit guarantee transaction.

DCA offers four products:

1) **The loan guarantee.** This guarantee is used for project-type enhancements and in cases where the borrower, lender, and uses of the loan proceeds are known.

2) **The loan portfolio guarantee.** This guarantee provides partial coverage on a portfolio of loans, mostly for one recipient financial institution. DCA takes the risk of a broadly defined category of bank loans to induce local banks to extend credit to an underserved sector. Individual borrowers under a loan portfolio guarantee are not predetermined at the time the agreement is signed, but must fall within a pre-agreed definition of eligible borrowers, which include small businesses operating in a specific geographic area.

3) **Bond guarantees.** DCA supports issuance of bonds by financial institutions, private sector corporations, or sub-national entities. The funds generated help raise local funds for development finance if domestic financial markets are sufficiently developed to issue domestic bonds.

4) **Portable guarantees.** These are guarantees on a loan between an identified borrower and an unidentified lender.

The DCA loan guarantee product is most commonly used, providing a donor-promoted service delivery structure operating with a single recipient financial institution whose loans are partially guaranteed.