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The Continent's Poor: ¿A new Niche for Traditional Banks?

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Background

During the last five years, banks in Latin America and the Caribbean have expanded financial services to low–income households. This type of lending, which has grown widely during the last 30 years, was traditionally performed by non-profit organizations that focused on primarily female microenterpreneurs. The cooperative movement that emerged in Europe at the end of the 19th century (and became very popular in our continent in the mid 20th century) can serve as background to this new phenomenon.

The microfinance movement emerged in the early 1970s[1]. In 1976, Professor Muhamad Yunus created the Grameen Bank (recently honored with the Nobel Prize) and the world formally recognized microcredit as a global phenomenon. Before long, the international community recognized the quality and growth rates of microcredit portfolios and embraced this developmental tool. Microfinance institutions (MFIs) assumed the leadership of the movement. These MFIs normally are locally rooted while maintaining ties to international networks, which in turn provide a means of exchanging both experiences and lessons learned as well as an essential funding mechanism to support MFIs' rapid growth.

In our region, the transformation of PRODEM into BancoSol in Bolivia ushered in a new era. It became clear that the demand for basic microcredit services was virtually unlimited. In order for the movement to accomplish its social mission, MFIs needed access to commercial sources of capital. A new vision began shaping the industry and many innovative services emerged. Specialized funding sources, credit rating agencies, and consulting companies were created. By the mid 1990's, the sector's tremendous potential, both as a tool for economic development and as profitable business proposition, became apparent. Simultaneously, it became evident that clients needed access to a range of services that extended far beyond the credit-only model available at the time. From savings to insurance to pensions, clients desired a variety of products adapted to their particular needs.

Examples of tremendously successful institutions surfaced in countries such as Colombia, Bolivia, Peru, and the Dominican Republic. These organizations use different solutions to the obstacles. Yet, each shared a common characteristic: they offered portfolios that were more solid and profitable than those found in traditional commercial banks. After the transformation of PRODEM into BancoSol, other institutions on the continent sought regulation as an access to the necessary capital to maintain their rapid growth.

The high performance rates of these institutions were noted by traditional banks, which had begun to equip MFIs with resources. Spurred on by the success of MFIs, a few banks developed their own portfolios with mixed results. It is worth noting that, as the industry

[1] In 1973, Accion Internacional issued the first microcredit in Brazil. http://www.accion.org/about_our_history.asp)

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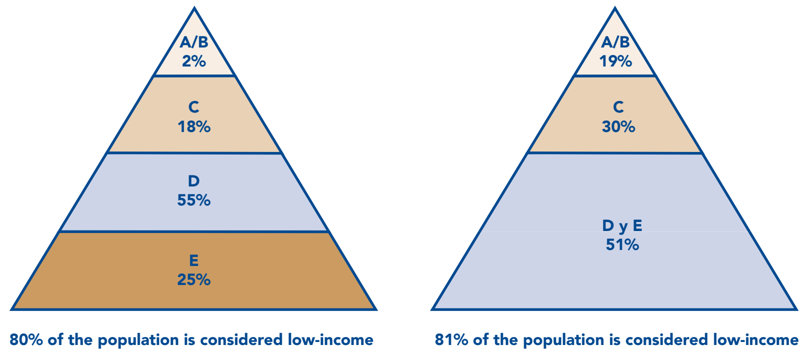
developed, countries with the largest economies on the continent (Argentina, Brazil, Mexico, and Venezuela) remained on the fringes of the sector, yielding results that were rather poor when compared to the size of their respective markets. (Figures 1 and 2).

At the beginning of this decade, policy-makers in Venezuela, Brazil, and Colombia decided to compel banks to enter the microfinance field at the start of the decade. While this approach forced banks to confront the challenge of providing services to low-income clients, governmental compulsion in this fashion is essentially wrong. Banks lacked, and continue to lack, a comprehensive understanding of the microfinance sector to adequately design products and services that reduce risks while still responding to customers need.

In the last five years and with support from organizations such as the Federation of Latin American Banks, Women's World Banking, the Inter-American Development Bank, and ACCION International a number of banking institutions have successfully entered the microfinance field; leading the way for other banks to follow and having benefited already hundreds of thousands of clients in the region.

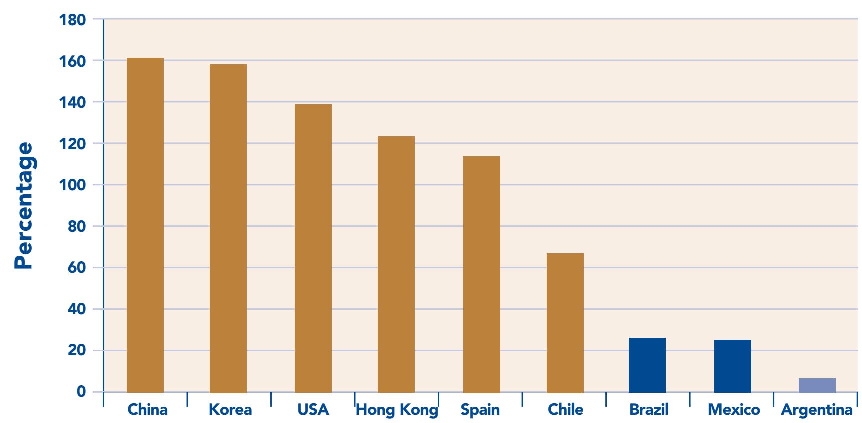
Banks have been especially successful in countries with large economies and established banking industries. Below we will

Figure 1. Population by Income Level



Note: Monthly income in US$:
Mexico: B/A =High>US$1,300; C =Intermediate=US$1,201 -1,300; D = Low = US$201-1,201;
E = Marginal <US$200. Brazil: B/A> US$1,750; C=Intermediate US$601< 1,750; D= Low US$176<600; E = Marginal <US$
Source: Erublisky (2006); Septién (2006)

Figure 2. Banking Sector's Assets/Gross Domestic Product (GDP) December 2005



Source: Etubilsky (2006), Septién (2006).

present four high-profile banks in Brazil and Mexico that are interesting case studies of this phenomenon. These institutions offer similar services to the ones traditionally provided by the microfinance sector. Yet they do so by drawing on innovative technologies and distribution channels that nimbly respond to the specific needs of the banking industry.

The Mexican Experience

One of the most relevant case studies is BANORTE. Founded 106 years ago, BANORTE is the only locally-owned commercial

bank of national presence in Mexico. BANORTE encompasses four regional banks, services more than 4.6 million clients, and netted results of US$402 million dollars as of September 2006.

The BANORTE group decided to explore the microfinance market in 2003 and, in 2004, a pilot project was launched to test the viability of the sector. It is important to note that, for this purpose, BANORTE decided to create an independent institution, a SOFOL[2] with a different brand name Créditos ProNegocio. ProNegocio designed a specialized network of branches providing individual loans, electronic banking, and insurance to this market niche. Meanwhile, BANORTE provided saving services to clients. In addition to creating a separate brand and structure, the BANORTE experience display three characteristics that have made it a leader in the microfinance market.

First, ProNegocio realized from the start that it had to fully understand its target market in order to be successful, so most of its initial activities were directed toward that end. This understanding allowed them to develop an adequate marketing strategy using images and slogans that were familiar to customers and stressed their own values and circumstances. Furthermore, the images were placed at the market place and recruitment shifted to the workplace as new clients were enrolled by current clients.

ProNegocio's marketing campaign has been immensely successful, yielding better-than-expected results. In a short time, ProNegocio became a leader in the market with a recognized brand. Furthermore, focus groups demonstrate that clients are pleased with the services provided. Curiously enough, clients identify ProNegocio as part of the BANORTE group. This positive identification has increased BANORTE's own brand among this customer base, which in turn has increased demand for services.

Another key to the success of ProNegocio can be found in the resources that have been devoted to developing a well-trained staff throughout the company. An important effort has been made to provide the best training available. This training is standardized throughout the organization and continuously updated so that loan officers are up to date and make constant progress in their careers. ProNegocio's investment increases productivity, causes employees to take pride in their work, fosters a healthy sense of competition, and allows them to feel that they are part of a team.

Finally, ProNegocio is working hard to develop a sound portfolio by contracting the services of international consultants through the support of agencies like the US Agency for International Development (USAID).

It is important to note that ProNegocio relies on BANORTE for operational support as well as for human resources. This provides a useful solution to many logistical needs but internal coordination is still critical in order to maintain planned growth rates.

At the end of 2004, the ProNegocio pilot had established three branches. By the close of 2005, the bank had expanded to 39 branches and 16 thousand loans. Growth continued through 2006 and, as of September, the bank now manages 90 branches and about 33,000 loans representing approximately US$54 million.

These outstanding results are shared by another Mexican bank, the Banco Azteca. Banco Azteca is part of Grupo Salinas, a conglomerate of Mexican businesses that started operations in October 2002. Realizing the scarcity of banking services, Banco Azteca saw a natural opportunity to expand. Low-income populations in need of credit were already being served by the Grupo Electra, an affiliate of the Grupo Salinas which has sold and distributed appliances to low-income households for 35 years. Banco Azteca's entrance into the microfinance market was tremendously successful: as of June 2006, their portfolio accounted for US$1,502 million dollars representing a total of seven million active loans.

[2] SOFOL (sociedad financiera de objeto limitado): Mexican nonbanking financial intermediaries.

In addition to the Bank, Grupo Salinas created three additional institutions to provide services to low-income entrepreneurs. Pensions were given through AFORE Azteca, [3] which after only three years of operating has already developed a portfolio representing 1.3 million pensioners and managing US$1.4 billion in assets (August 2006). Grupo Salinas also established Seguros Azteca. Seguros Azteca has issued 5.8 million policies in the two years following its creation. Finally, credit is given to poor entrepreneurs through Círculo de Crédito, a credit bureau focused on low-income households. After only one year, Círculo de Crédito has 12.5 million clients, accounting for 28.4 million operations.

Undoubtedly, the swift growth of Grupo Salinas over the last four years has gotten the attention of both the regional microfinance and banking industries. It should be noted that a sizable percentage of Banco Azteca's business consists of financing the appliances distributed by Grupo Electra. Yet, this does not detract from the success of Banco Azteca. Innovative product design as well as the tangible commitments from senior executives with low-income entrepreneurs have resulted in a range of services appropriate for this niche market and follow the bank's general pattern of growth. For example, since the development of the product known as "Empresario Azteca" at the end of 2005 until October 2006, Banco Azteca reported having served 142,200 microentrepreneurs, which accounted for US$116 million dollars. This type of growth has never been seen before in the Latin American and Caribbean region.

What factors have contributed to the success of Banco Azteca? First, Grupo Salinas's commitment to low-income populations is well known, especially by the clients themselves. The priority of the poor can be seen in the institution's public and private discourse. With this commitment comes a profound respect for the client. Microentrepreneurs appreciate being regarded as equals.

Second, Banco Azteca provides services that are flexible, convenient, and responsive to the size of demand. Loans are authorized in 24 hours, setting a standard of rare speed within the industry. Banco Azteca's state-of-the-art technology allows it to authorize 13 thousand loans daily while managing an average of 7.3 million operations in a given week. The scope of operations has never been seen before in this market. As of June 2006, over 17,000 employees worked in 1,516 operating branches of Banco Azteca. These branches are open 365 days a year from 9 a.m. to 9 p.m. and use innovative technologies adapted to the needs of customers, such as fingerprint recognition, these branches provide services that are truly adapted to their clients. The speed and innovation of Banco Azteca indicate that the bank provides services based on the needs of the client, not the constraints of the competition. This preference for the poor, although considered risky by some, is at the heart of Banco Azteca's success.

In many institutions, management provides services at the pace set by the growth of their microfinance portfolios, in average around 50% in LAC. Although this growth rate is higher than other economic sectors, the demand for microfinance services is much higher. For the first time in our industry, an institution has tried to develop the internal capacity to actually meet the real demand of the sector instead of forcing the sector to grow in accordance with the capacity of the institution.

The wide range of innovative services offered by Banco Azteca is a final factor in the institution's success. Banco Azteca provides a myriad of services (see Figure 3), many of which are not usually available to microentrepreneurs. At Banco Azteca, innovation is ongoing as the Bank is always trying to closely respond to the demands of its clients.

[3] Mexican institution specialized in managing pension funds.

Figure 3: Services offered by Banco Azteca

DEPOSITS SERVICES	• Guardadito • Inversión Azteca • Cuenta Socio	• Cuenta Nómina • Tarjeta de Débito
CREDIT SERVICES	• Credimax (Consumo) • Préstamos personales • Canales de Terceros • Procampo • Crédito Estudiantil • Empresario Azteca	• Hipotecario • Automotriz • Transporte Público • Micronegocio Azteca • Tarjeta de Micropagos • Tarjeta de crédito
OTHER SERVICES	• Banca por Internet • Banca Telefónica • Cajeros automaticos • Pagos interbancarios • Punto Azteca	• Compra – Venta de dólares • Banca Seguros • Domiciliación • Aceptación de cheques de otros Bancos

Source: Septién (2006)

The Brazilian Experience

Brazil is another large country in the region where banks are making serious efforts to provide financial services to its population on a massive scale. This phenomenon of growth arises, in part, as a result of a regulation established at the end of 2003 by the government of President Lula Da Silva requiring local banks either to place two percent of their demand deposits into microcredit operations at a monthly rate of, at most, 2 percent or to deposit those funds in Central Bank of Brazil at a zero rate.[4] The response of the banking sector has been moderate and, at best, reinforced the industry's belief that the government should not force banks to provide microfinance services. Yet, the regulation raised awareness on the issue of expanding financial services to the poor, and the banking sector is responding with innovative solutions that provide concrete results.

In 2000, the Central Bank of Brazil approved a regulation permitting commercial banks to use banking correspondents as a means of extending their operations. This tool was conceived in order to service areas that did not have a bank branch due to their size or relative isolation. Although not specifically designed to serve low-income households, it has helped banks both to learn more about this market segment and to design products specifically for it. Two examples have attracted the industry's attention: Lemmon Bank and Bradesco-Banco Postal.

Lemmon Bank, a privately owned bank, was created in 2000 in response to the banking correspondent regulations while Bradesco-Banco Postal is the result of a partnership between BRADESCO and the Brazilian post office. Established in 1951, BRADESCO has provided personal banking services for over 60 years and is the largest private bank in the Brazilian economy.

The Lemmon Bank selectively chooses which businesses will represent it within a given local community. Following selection, Lemmon either creates an additional structure, such as a service station inside a store, or provides services at the business's cash register. Lemmon focuses on transactional services such as utility payments. Since operations began in July 2002 until October 2006, 5,106 service sites have been created in 1,300 municipalities across 18 Brazilian states. As of June 2006, these service sites had helped 4.5 million people and managed 55 million transactions.

Although Lemmon's services are primarily transactional, the bank has also developed two attractive credit products. The first relates to utility companies - Lemmon Bank finances the payments that the utility companies will receive. This product could be the basis for another study. The second service is a personal credit pilot product.

The personal loans offered an initial limit of R$150 to R$1,000

[4] Subsequently the terms were more flexible and the banks were allowed to allocate their funds in the microfinance market up to a 4% percent a month.

(approximately between US$70 and US$467) over a three to twelve months term. Although these loan sizes fit the microfinance market niche, Lemmon is not concerned with how the loan is used nor has it developed any sort credit methodology based on cash flow analysis. Its analysis is based on a client's payment history and loan increases are decided based upon clients' payment behavior.

For a long time, the microfinance industry has wondered if microcredit, as known in other parts of the globe, is a viable solution in a country like Brazil, with a large, dispersed, and heterogeneous population. Lemmon Bank's lending methodology, based on information it gathers from transactions, appears to be a real answer to the lack of access to financial instruments of Brazilian low-income entrepreneurs. The latest figures seem to point in this direction: more than 60 percent of clients have a monthly income lower than US$1,000 dollars and 62 percent identify themselves as being self-employed.

Lemmon Bank plans to widely release the product once it perfects the scoring model basis of the methodology. However, using this model presents challenges. Among these challenges is the possibility of fraud, the difficulty of managing new service locations, and the distribution of new products to correspondents. Lemmon Bank has already begun to confront these obstacles through the use of management tools, strong internal control, close communication with correspondents, and training.

BRADESCO, on the other hand, took the same tool and did something completely different. It partnered with the Brazilian post office to create Banco Postal, which uses of post offices throughout the country to provide banking services to 45 million of Brazilians previously excluded from the banking system. BRADESCO invested R$450 million (approximately US$200 million) into training post office personnel, refurbishing existing infrastructure, and purchasing the necessary equipment. At Banco Postal, clients can open accounts, access window services (account balances, statements, withdrawals, and deposits), online loan applications, credit cards, and pay their utilities and taxes.

Since Banco Postal opened its doors in 2002, 5.6 million people have obtained banking services and 1,700 offices have been established (in 87 percent of Brazilian municipalities) affecting an estimated 14.7 million people. Eighty-eight percent of those customers have monthly an income lower than US$575, 55 percent are women, and 85 percent are between 18 and 60 years of age.

The geographic scope of operations is vast: 405 of the 1,700 offices are 100 kilometers or farther from any financial service center and 75 of them are simply not accessible by land.

To date, 575,000 credit operations have been carried out, representing a total loan portfolio of R$423 million (approximately US$200 million). This portfolio consists of four primary products: microcredit (70 percent), rural (5 percent), home building (0.28 percent) and others loans (23 percents). BRADESCO has reported that more than 76 percent of the 5.6 million of clients have a savings account and that 100 percent of them own a credit card. The services provided by BRADESCO have increased tax revenues for the central government. Local economies have also experienced rapid growth. For example, after the opening of a bank office, the municipality of Autazes, which is located in the middle of Amazonia and has a population of 24,000, has reported a 30 percent increase in the number of new businesses.

Although Banco Postal and Lemmon Bank both use banking correspondents, their approach differs radically. BRADESCO has marketed its well-known brand name and extensive local presence to partner with another widely known organization (the post office). This partnership has allowed BRADESCO to sidestep many of the obstacles faced by Lemmon Bank as Lemmon must seek out different partners in

each new location. Also, low-income clients already know and trust the post office, making them more likely to use the banking services that BRADESCO is marketing. BRADESCO's previous business experience also allowed them to design financing and savings products more rapidly than Banco Postal. Finally, the impact of BRADESCO's services was wider because they had a larger initial investment of cash and there were already a number of post offices spread throughout the country to serve as a base of operations.

Lessons Learned

Three characteristics seem to be behind the excellent results achieved by the four institutions analyzed here:

Unconditional Commitment from Upper Management. Unconditional commitment from the upper management is key to the successful provision of banking services to low-income populations. Management should regard microfinance as a profitable and feasible business and not as an altruistic mission or a corporate image-enhancer. Without this commitment, the bank will not be willing to invest resources or make necessary changes in the bank's culture in order to adjust to these new clients. This also provides a good indicator of the bank's staying power in the microfinance sector.

Comprehensive Knowledge of the Market, Low-income Entrepreneurs and his/her Household. Practitioners must understand their target clients as well as their particular market niche. Although it takes different forms, this knowledge is evident in all four case studies. Such knowledge comes easily to Banco Azteca. Azteca's owner, Electra, has worked in microfinance for thirty five years; she houses most of the Bank's branches. BANORTE has used marketing tools to understand the market and after three years, shows a deep understanding of its niche. BANORTE's success is confirmed by the widespread acceptance of ProNegocio. BRADESCO-Banco Postal searched for a partner, the post office, which already possessed knowledge of the market. Finally, Lemmon Bank has collected information about the market in order to achieve strategic positioning.

Formulas cannot be copied. However, Technologies can be adapted to various markets and institutions. All four banking institutions surveyed provided services rooted in their particular situation and institutional culture. They responded to the needs of clients, but they managed to maintain their individuality and maximized their particular strengths. These institutions also turned to the use of state-of-the-art technology as a tool to expand services.

Do the continent's poor provide a new market niche for traditional banks? According to our study, the unmistakable answer is yes: the poor are a new, attractive and feasible market for banks. With this yes in mind, we must continue to study the market, develop creative solutions, and expand banking services to low-income families across the continent.

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BIO

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Credit Guarantee Systems in Latin America: Taking Stock

Juan José Llisterri

Introduction

Lack of access to competitive bank credit is one of the main problems faced by micro, small, and medium enterprises (MSMEs). Given the insufficient development of financial markets, this constraint affects enterprises of all sizes, but access is much harder for MSMEs.

Entrepreneurs feel that banks do not give them enough attention, do not consider them creditworthy, or require excessive guarantees in order to access credit, even when they are willing to pay higher interest rates. This forces entrepreneurs to seek other sources of financing that are usually less competitive. Moreover, banks believe that the cost and risk involved in lending to MSMEs are too high. Therefore, when default occurs, they have no other choice but to require sufficient guarantees that will cover the principal and interests, as well as the high collection costs resulting from inefficient legal systems. Obtaining information on borrowers is one of the main challenges that impact the cost of loans to small-sized businesses. Credit bureaus can play a very positive role in this respect. Risk issues are related to the quality and quantity of the collateral that borrowers can provide, and to the ability of the financial institution to enforce them in the event of default. A series of measures to achieve greater availability of collateral and efficient contract enforcement can be taken to foster MSME's access to credit.

International standards for capital requirements and loan loss provisions for financial institutions also have an impact on the quantity and quality of the assets that can be used as collateral. Prudential regulation of the financial system also affects the way small businesses access bank credit, placing them in an unfavorable situation *vis- à- vis* larger businesses, which can provide better collateral in terms of quantity and quality.

Given this situation, governments are looking for ways in which small businesses with good projects could gain access to competitive credit. In addition, the interest of policymakers is sparked when the topic of small businesses emerges. When attention is focused on small businesses, political pressure is placed on policymakers. The development of guarantee systems is a recurrent alternative that has repeatedly been proposed in Latin America and other regions of the world, even when past experiences do not provide enough evidence of its effectiveness.

Due to the interest and demands that have once again surfaced in the region, the Inter-American Development Bank (IDB) assessed existing guarantee systems in eight Latin American countries, from which important lessons can be drawn (Llisterri *et al.*, 2006). Some experiences in the region have shown positive results, but none of the cases analyzed show undisputable additionality, and in most of them, such additionality is seriously questioned. Nevertheless, the desire of governments to move forward with initiatives in support of MSMEs, as well as the mixed results from various international experiences, demand a review of this issue.

Credit Guarantee Systems and Programs

Guarantee systems aim to facilitate access to credit for MSMEs by providing partial or total guarantee for the repayment of the principal and interests to the lender, taking on part of the risk assumed by financial institutions when lending to small firms.

The participation of the public sector through these to guarantee systems is justified due the need to overcome the limited access to financing faced by small

firms. Such limited access stems from asymmetric information, and the higher cost of processing smaller loans, and enforcing loan contracts.

Asymmetric information in lending forces the lender to take on the borrower's moral risk. In fact, an entrepreneur may decide not to allocate his profits to repay the bank, especially if –as it usually happens with MSMEs— the leverage is high. When banks do not have information on the entrepreneur's willingness to repay, they limit the access of MSMEs to credit. Moreover, lenders react defensively by increasing interest rates indefinitely, which could lead to adverse selection of borrowers since those with lower risks (usually more risk averse) cease to apply for credit, and those with higher risks (usually less risk averse) are willing to accept any price. As a result of these market failures, access to credit is rationed. In other words, good borrowers with good projects are unable to find financing. This implies that the market itself, in the presence of market failure, is not able to provide the same financing opportunities to MSMEs as it does to large enterprises, even when they have the same repayment ability, and they are willing to pay higher loan interest rates (BID, 2005).

Policy actions seek to mitigate market imperfections, and reestablish sustainable market conditions. One of the tools normally suggested to reduce the cost and risk of lending to small businesses are credit guarantee systems, particularly when the firm is new to the banking system.

Ideally, credit guarantee systems could contribute to the increased access to financing of small businesses, without forcing banks to relinquish their own credit risk evaluation methodologies. This assumption applies to cases where banks have a potential clientele of MSMEs with good projects, and good prospects of generating the necessary cashflow to repay the loan, but which do not meet the required collateral established by both, banks and regulation. A guarantee institution can provide a guarantee that complements insufficient collateral in return for a price received from the bank, which is normally charged to the borrower, or from the borrower himself. This guarantee, when liquid, reduces the risk assumed by the bank, as well as the collection costs in case of loan default. Therefore, in theory one could think of a plan where there is a balance between the amount paid for the guarantee, and the benefits that it provides to the financial institution so that they can incorporate new clients for credit. Usually, the objective is that they eventually become permanent clients without requiring new external guarantees after working with them for a period of time, and getting to know their credit performance and behavior.

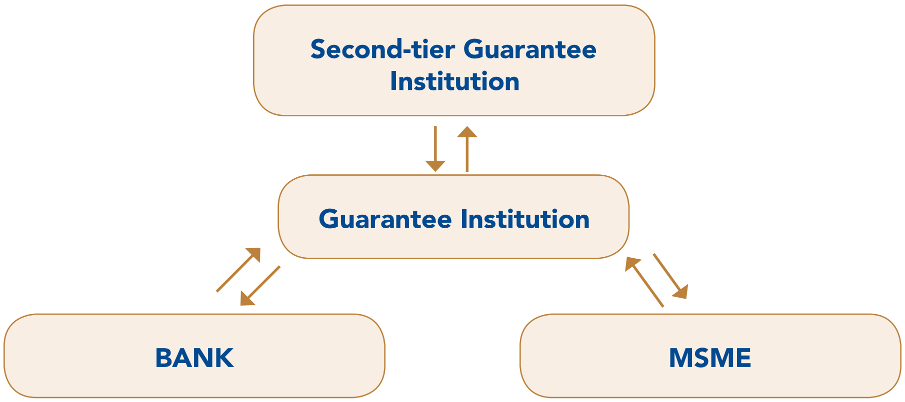
There are different operational models that perform the most general function of guarantee systems or schemes. To provide detailed examples of different experiences in the world, several aspects should be taken into consideration, including differences in the legal characteristics of its constitution, decision-making mechanisms, the public or private origin of the funds, the type of credit covered by the guarantee, its validity in time, and the level of coverage for the lending risk. In all these cases, there is a third party involved in the direct lending relationship between MSMEs and the bank, which backs the guarantee of the borrowing company with a guarantee given to the lending bank. The flow of contractual relationships between each of the agents, as pictured in Figure 1, differs in their nature and contents, depending on each modality.

The following basic models can be mentioned:

a) Guarantee Funds

They are mainly funded with public resources and managed by entities that have agreements with commercial banks, which establish criteria and procedures that are then used to assign a guarantee from the fund to a certain percentage of a predefined MSME lending portfolio. The guarantee is automatically applied to individual operations that meet the eligibility criteria requirements of the guaranteed

Figure 1. A Typical Credit Guarantee System



portfolio. In other words, the fund does not assess the credit risk of each operation, but that of the portfolio as a whole. It is the financial institution the one that assesses the risk, and then decides to guarantee eligible borrowers under the conditions previously established with the fund. This option is also called portfolio guarantee, and is provided at a price or guarantee commission that banks charge borrowers.

In the event of the borrower's default, the bank notifies the fund's administrator, who then verifies that the beneficiary complies with the eligibility requirements and those inherent to the guaranteed operation. The fund also makes sure that the bank tries by all means to recover the loan (often including having initiated legal action), and finally disburses the share of the credit due for payment that is covered by the guarantee provided by the fund to the lending institution. The collection of loans in default and the distribution of the amounts recovered among the financial institution and the fund are regulated by the agreement between the fund and the financial institution.[1]

b) Credit Guarantee Companies

Funded by the public sector, and in some cases private enterprises, credit guarantee companies also sign agreements with banks establishing conditions under which they guarantee loans to individual businesses. Credit guarantee companies make their own assessment of credit risks before granting a guarantee. The bank also conducts its own evaluation, especially if the guarantee provided by the credit guarantee association does not cover 100 percent of the credit risk. This modality is also called retail guarantees, as opposed to portfolio guarantee. Mutual guarantee companies (MGCs), which exist in several countries in the region, have two types of participants: participants who are eligible to receive guarantees from the credit guarantee companies, and sponsor (protecting) partners, which are public entities or large enterprises, providers or clients of the participating MSMEs. In this way, MSMEs receiving the guarantee are at the same time active members of the MGC, in which entrepreneurs grant guarantees to each other with the backing of donations and support from the public sector.

Since they evaluate individual risk, and can potentially provide banks with new clients whose risk has already been assessed, mutual guarantee companies have the capacity to negotiate better repayment terms or interest rates for MSMEs guaranteed by the MGC. Borrowing MSMEs are required to pay a guarantee commission, and often an assessment fee, as well as provide funds to the MGC's equity.

If the MSME does not pay back the loan, and once the requirements in the agreement with the guarantee company have been fulfilled, the bank will claim the reimbursement of the correspond-

[1] Examples of this type of funds include Fondo de Garantía para Pequeños Empresarios (FOGAPE), Chile; Fondo Nacional de Garantías, Colombia; Fondo de Garantía para Préstamos a la Pequeña Industria (FOGAPI), Peru; Fondo de Garantía para la Promoción del Empleo y la Renta (FUNPROGER), Brazil; and Fondo de Garantías de Buenos Aires (FOGABA), Argentina.

ing percentage of the loan in default. The guarantee company, according to the level of coverage of the default risk, will have the responsibility of answering for those loans in default.[2]

c) Credit Guarantees to Microfinance Institutions

A specific option are guarantees provided by private or public entities, as well as donor agencies, which guarantee the portfolios of microfinance institutions (MFIs) so that they can obtain funds from other sources, and lend them to microenterprises. In this case, microenterprises access credit under specific microfinance terms. Portfolio guarantee is generally used by the MFI that do not take in deposits, so that it can obtain funds from other sources, usually bank loans. In fact, literature on this type of experience is more focused on the peculiarities of microfinance and how operations are mostly conducted through nonbanking institutions, and is therefore different from the literature that analyzes guarantee systems for bank credit.[3]

d) Credit Insurance

Credit insurance differs from credit guarantees in that the insurance narrowly covers only specific, pre-defined risk. Probability of occurrence for these pre-defined events can be objectively measured through actuarial methods. For example, credit insurance can cover, the risk of death or disability of the entrepreneur, exchange rate risk, or even commercial risk in the case of exporters. However, insurance companies, have yet to start measuring default risk due to the difficulty at evaluating the probability of decisions being made by the entrepreneur and his behavior. Nevertheless, the increased use of credit scoring techniques applied to micro and small enterprises opens the possibility of bringing credit insurance within the reach of insurance companies.[4]

e) Other programs to mitigate the credit portfolio risk in MSMEs

In the last few years, a new formula for guaranteeing credit to MSMEs has been generalized. It consists in guaranteeing not a percentage of the credit portfolio, but 100 percent of what is considered "first losses" or expected losses, which are calculated according to parametric techniques established by the Basel II Accord for estimating credit portfolio risk. In this arrangement, the public sector covers the risk facing banks when lending to MSMEs during a given period, as long as the risk is not higher than the one expected for each portfolio. If losses are lower than expected, there will be no need to use the entire public fund. If losses for the guaranteed portfolio are higher than expected, the bank will assume responsibility for losses in excess. Because of the structure and how it works, this type of guarantee can be managed by means of temporary programs that are in place until desired goals are reached.[5]

f) Second-tier Guarantees

Second-tier guarantees make sense only in the case of consolidated guarantee systems, in which a number of first-tier guarantee entities reach the limits of authorized leverage and find that the use of second-tier institutions is a good alternative to expanding operations without having to raise capital. However, second-tier guarantees can also be used in guarantee funds with a proven satisfactory performance that can be acceptable in order to increase their authorized leverage.[6]

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2 Guarantee associations can be found in Argentina, Venezuela, and El Salvador.

3 This modality has been analyzed by, Lopez and Angulo (2005), and Flaming (2006), among others.

4 An important experience in the use of credit insurance in the region was that of Corporación de Fomento de la Producción (CORFO), Chile, with their program "Cupones de Bonificación de Seguros de Crédito, CUBOS." The evaluation of the program was not favorable, which led to its cancellation.

5 Mexico's Secretaría de Economía provides the only examples in the region. The experience with FUNDES first and then with Nacional Financiera (NAFIN) is still recent, so it is too soon to characterize it as a consolidated model.

6 Even though there are several second-tier funds in different countries in the region that have mutual guarantee associations, none operate at higher than testimonial levels. However, some second-tier operations have been carried out, as is the case with the Fondo Nacional de Garantías de Colombia.

Guarantee Systems in Latin America

Guarantee systems in the region are heterogeneous. They not only present characteristics of two institutional models, guarantee funds and mutual guarantee companies, but different forms can be found under each model as well.

Table 1, shows some of the differences in the volume of operations and impact of guarantee systems in eight countries analyzed in the previously mentioned study.

In general, guarantee funds have a wider scope in terms of the number and volume of operations and the number of enterprises they serve. These funds deal with relatively smaller enterprises, and reach higher levels of leverage. Credit guarantee companies have a mutual or reciprocal nature; have a smaller number of clients, mostly of medium size, rather than small; and for various reasons have not reached leverage levels that can justify the equity invested in them or in second-tier schemes. It is clear that those two different models aim at different types of clients.

The experiences in the region are so varied that it is impossible to identify a model that can be followed in the rest of the countries, since the additionality of each of the systems has not yet been proven. In Chile, FOGAPE has shown the greatest progress in its relatively superior impact as well as evaluation efforts and initial findings on positive additionality. But, at the same time, one should consider the level of development achieved by the Chilean financial system, together with other characteristics of its business climate, which are more favorable than in those of other countries in the region.

Some of the common features of the guarantee systems studied are:

- The systems in the region have grown since 2000, which coincides with the high levels of liquidity in the financial system. Liquidity leads banks to direct their attention to smaller enterprises, a market they are not used to working with and where they can find a new and possibly profitable segment. In addition, it should be noted that the development of guarantee systems occurred during an expansion of the economic cycle itself when default levels were low.
- Financial regulation and supervision of credit guarantee systems highly contributed to a more professional and transparent operation of such systems, achieved the reduction of loan provisioning, and generated trust and interest in banks in the use of guarantee systems.
- In the bank credit sector as a whole, guarantee systems have, at most, residual importance, except in Chile and Colombia.
- The capitalization of the system has mainly, and almost exclusively, been public.
- In some countries, funds have reached a certain level of financial sustainability, showing that it is possible to achieve this objective.
- Beneficiaries are mainly micro and small enterprises, and to a lower extent, medium-sized enterprises. The average amount of guaranteed loans varies between US$2,400 and US$18,000. In some countries, portfolio guarantees have been applied to microfinance institutions, regulated and specialized banks as well as nonregulated ones, and indirectly to microenterprises.
- With some exceptions, financial institutions require additional guarantees to those offered by the system, since these cover less than 100 percent of the credit. Only when the financed portfolio consists of microcredit does the guarantee of the system act as the sole guarantee.

In addition to the common or general characteristics of the guarantee systems in the region, there are also obvious differences in their operation and impact. Among the cases that were analyzed, two should be noted in light of the impact they have on

Table 1. Summary of Guarantee Systems in the Region

	Argentina	Brazil	Chile	Colombia	El Salvador	Mexico	Peru	Venezuela
Bank Supervision	SYES (even though SEPYME is the main administrator)	NO	YES	YES	YES	NO	YES	YES
Guarantee Concession Model	Individuals + Portfolio	Portfolio	Portfolio	Portfolio	Direct guarantee	Expected losses (SPYME - Fundes) + Portfolio (NAFIN)	Portfolio	Direct guarantee
Volume of Guarantee (2004) (Amount in US$ millions)	85	FGPC 129 FUNPROGER 361 FAMPE 1.3	332	367	10.6	n.a.	63	13.9
Volume of Guaranteed Credits (2004) *(US$ millions)*	85	FGPC 176 FUNPROGER 453 FAMPE 2.6	472	712	n.a.	NAFIN 995 SPYME991	147	n.a.
Number of operations (2004)	4,351	FGPC 1143 FUNPROGER 72,657 FAMPE 257	34,221	102,930	227	NAFIN 47,077 SPYME 20,412	60,475	SOGAMPI 337 Other MGA 346 Second-tier 180
Coverage (%)	100	FUNPROGER y FGPC Max. 80% FAMPE 50%-80%	Max. 80%	Depends on product: 50%-80%	100% (includes interests)	Umbrella Max 75% Max. expected loss es 2.4%	Max. 50%	Max. 80%
Loan Average *(US$)*	18,379	FUNPROGER 6,235 FGPC 153,981 FAMPE 10,117	13,796	Institutional 902 Portfolio 6,939	46,696	n.a.	2,431	n.a.

n.a.- Data not available

Notes.- SEPYME (Secretaría de Pequeña y Mediana Empresa y Desarrollo Regional - Argentina); FGPC (Fondo de Garantía para la Promoción de la Competitividad -Brasil); FUNPROGER (Fondo de Garantía para la Promoción del Empleo y la Renta - Brasil); FAMPE (Fondo de Garantía para la Micro y Pequeña Empresa - Brasil); NAFIN (Nacional Financiera - México) ; SPyME (Subsecretaría de Pequeña y Mediana Empresa - México), Sociedad Nacional de Garantías Recíprocas para la Mediana y Pequeña Empresas - Venezuela).

Source: Llisterri et al. (2006)

small enterprises: the guarantee funds in Chile and Colombia, and the coverage of expected losses program in Mexico.

Lessons Learned

The regulation and supervision of guarantee institutions acting as financial institutions are of critical importance, and, in their absence, any actions may prove unsuccessful or may result in losses or the incorrect use of funds that have been allocated for this purpose. Regulation does not guarantee the success of the system, but it does reduce the risk of major failures.

A proper regulation of the system allows for appropiate incentives to be established for financial institutions, as well as for guarantee institutions and borrowers. As guarantee institutions are supervised and regulation ensures higher quality, financial institutions will be able to eliminate or reduce credit provisions issued to guaranteed MSMEs. This type of incentives is key to banks . On the one hand, these incentives inspire confidence that guarantees have high levels of liquidity, which is attractive in and of itself when compared to any other type of guarantee that would imply costs and legal delays when enforced. On the other hand, it allows them to operate without having to tie up resources, which presents a very effective and measurable direct economic advantage. In addition, since a portion of the credit is guaranteed, they can venture into a new segment of the lending market, with a lower risk than in the absence of the system. Nevertheless, for these incentives to play a positive role they must be contained within certain limits to avoid potentially negligent behavior from both, banks and enterprises as well.

In this framework, the role of the public and private sectors can be clearly defined. The public sector is responsible for regulating the guarantee system, creating appropriate incentives for private banks participation, and supervising guarantee institutions. Equally, the public sector should create an adequate environment for lending activities, particularly in the areas of creditor's rights protection, proper registries (movable and non-movable assets, new enterprises), the legal system for contract enforcement, and credit rating offices. Another role for the public sector could be that of creating and capitalizing guarantee institutions, always under due regulation and supervision, transparency, professional management, strong participation of the private financial sector in operations to be guaranteed, and financial sustainability. Through guarantee institutions, the public sector shares the risks involved in commercial bank lending to small businesses. Still undefined is the issue of whether public participation must be limited to temporary programs to launch the systems, which after that need to continue operating on their own, or if there is a long-term need for support, with a timeframe yet to be determined.

In the private sector, banks and enterprises are the main actors. Banks share with the guarantee institutions the inherent risk of lending to MSMEs. However, banks should take up more risk as they learn how to manage risks posed by MSME loan portfolios. Instruments such as *credit scoring* and risk management as proposed by the Basel II regulations will allow for a more efficient and effective application of credit guarantee schemes. On the other hand, enterprises benefiting as clients from guarantee systems should profit from the opportunity to access financing and establish a credit history that should make them creditworthy without having to resort to further guarantees provided by the public sector.

Finally, before the creation of a new guarantee system is proposed, efforts should be directed toward analyzing obstacles to credit access, identifying alternative measures to improve access to credit, defining quantitative objectives and monitoring methods, evaluating impact and additionality, and distancing from political pressures that often go hand in hand with these programs.

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