

CREDIT GUARANTEE SCHEME FOR SMALL AND RURAL ENTERPRISES

Background:

Credit Guarantee Schemes are programs that ensure partial repayment of a loan in order to motivate lenders to lend to borrowers which would not have access to credit under normal circumstances. The growth of Small and Rural Businesses is imperative for any developing economy. Access to formal finance for this sector is a major problem hindering the growth of small and micro enterprises, particularly in the rural areas.

Given the impediments in the way of Small and Rural Enterprises in Pakistan to raise capital from the capital markets or financing from the financial institutions, the Credit Guarantee Scheme shall help in resolving severe credit rationing. The major elements of Credit Guarantee Scheme for Small & Rural Enterprises are as given below:

Capital Structure:

The initial seed money for the Scheme is GBP 8.0 million under the Financial Inclusion Programme (FIP) funded by the UK's Department for International Development (DFID), with the option of later being bolstered up through further allocation of funds from other sources including the Federal Government and international/bilateral agencies. The Scheme, with its initial seed money, is intended to serve as a role model for further expansion to other segments/areas, and attract additional funding from Government of Pakistan/ international donor agencies and the private sector.

Areas of Financing and Target Clients:

- **Geographical Restriction:** The Scheme is to be used as a tool for revival of economic and business activities in NWFP, FATA and Gilgit Baltistan (GB). Therefore, 50% of the Credit Guarantee Fund is reserved for small and rural enterprises of these areas. While priority will be given to small farmers with landholding of up to 5 acres for purchase of inputs like seeds, fertilizer, etc. under the Scheme. The remaining 50% of the Fund is to be allocated to selected clusters in other parts of the country. Initially, it is expected that demand for credit in the NWFP/FATA/GB will remain low so the Technical Committee on Credit Guarantee (TCCG) may manage the exposures as appropriate.
- The target clusters in parts of country excluding NWFP, FATA, GB shall be selected based on their geographical concentrations and other structural commonalities. While, the TCCG is empowered to add further areas, following are the major priority clusters to be targeted under the scheme.

- Surgical Instruments
 - Sports Goods
 - Fans
 - Ceramics
 - Cutlery
 - Fisheries
 - Agricultural services like Cold Storage, Quality seeds & Fertilizer, Bio gas etc.
 - Retail Enterprises
- Preference for use of the Guarantee Fund shall be given to only fresh/new and collateral-deficient borrowers. Participating Financial Institutions (PFIs) will ensure that the guaranteed loans are not used for purposes contradicting the very objective of the Scheme, i.e the facility will not be used for debt swaps/adjusting an existing loan, buying company shares or member of a partnership, or financing interest payments etc.

Risk Sharing with the Financial Institutions:

The Scheme shall share the risk with Participating Financial Institutions (PFIs) by guaranteeing up to 60% of the PFIs' fresh portfolio of financing to Small & Rural Enterprises.

Individual or Portfolio Guarantee:

Instead of the evaluation of each and every loan, portfolio (principal amount only) of new loans (i.e. loans extended after launch of the Scheme) of a PFI which meet the specific criteria is to be guaranteed under the Scheme to the extent of its allocated Credit Guarantee Limit (CGL). The issuance of Credit Guarantee is subject to compliance with provisions of the Guarantee Scheme and other instructions issued by State Bank from time to time, as deemed necessary. SBP/SBP BSC (Bank) will have right to withdraw its approval of guarantee if it is discovered at any stage that the borrower was not eligible for financing under the Scheme at the time of extension of the loan facility. In such an event, the PFI will bear 100% of the credit risk of such borrower. The PFIs shall be required to submit monthly or as and when required reports of their financing to Small & Rural Enterprises and compliance with the criteria of the Scheme to 'Credit Guarantee Office (CGO)' in the SBP BSC (Bank) for its evaluation. The CGO is authorized to undertake post-disbursement audit of selected cases to ensure that by and large the criteria has been complied with to acceptable levels by each PFI.

The CGO shall submit a report of performance to TCCG through SME Finance Department, SBP, on a quarterly basis.

Pricing of the Loans under the Guarantee Scheme:

Since the guarantee facility offered to the PFIs can be considered a form of cash collateral the applicable mark-up rate will be up to a maximum of KIBOR (3 Months) + 300bps. However, in cases where the SBP has provided a refinancing facility (such as Agriculture Loan Refinancing Facility and SME Credit Refinancing Facility), the interest rate cap allowed by the SBP to the PFI under a particular facility would prevail.

Selection of PFIs:

State Bank will select banks to serve as the Participating Financial Institutions (PFIs) and allocate Credit Guarantee Limits (CGLs) to each PFI. For the component of scheme reserved for NWFP, FATA & GB, all banks are considered as PFIs while for other component at least four (4) banks in good financial condition and having considerable share/expertise in small/ rural /agricultural financing shall qualify for receiving credit guarantee under the Scheme. To ensure transparency, all commercial banks will be invited to show their willingness to participate in the Scheme. The willing banks shall then be evaluated and rated on pre-established criteria, the major ingredients of which are as under:

- ⇒ Branch Network in SME Clusters / Agriculture Target Areas.
- ⇒ Share of SME & Agriculture Finance in Banks' Total Advances.
- ⇒ SME & Agriculture Loans Overdue Position (NPLs).
- ⇒ Small Business & Agriculture Finance Experience.
- ⇒ Product Development Initiatives.

Guarantee Limits for the PFIs:

Under the Scheme, PFIs will be allocated portfolio guarantee limits for small & rural enterprises on a quarterly basis. CGO will monitor the performance of PFIs viz-a-viz their allocated limits on quarterly basis and more frequently if deemed necessary. The allocated limits of the PFIs shall be dynamic and adjusted on quarterly basis keeping in view the overall financial position of the PFI, its drive to increase non-guaranteed SME/Rural Financing, performance of the guaranteed portfolio i.e. achievement of allocated limits, NPLs of the guaranteed loans, claims on guarantee fund, etc. The ***Dynamic Limit Allocation Mechanism*** will serve as a second measure for reducing adverse selection problems on part of banks (first being the sharing of credit risk of at least 40% of the in loan amount).

Management of the Scheme:

The Scheme is to be managed through high-end **Technical Committee on Credit Guarantee (TCCG)** comprising representatives from Donor Agency, Pakistan Banks Association (PBA) and SBP, to monitor and oversee the performance of the Scheme. Besides TCCG, **'Credit Guarantee Office (CGO)'-Unit** also is to be established at SBP BSC Offices to serve as the operational arm of TCCG for implementation of the Scheme. The TCCG shall arrange for the training of SBP officials in all necessary areas to facilitate effective implementation of the Scheme.

Eligibility of Borrowers:

The borrowers under the scheme will be Small Enterprises. The Selection Criteria for Eligible Borrowers will include:

- ▶ Regular and estimable positive cash flows
- ▶ Borrowers within the defined Target Market
- ▶ Be in conformity with the PRs for SMEs/Agr. Financing
- ▶ Should have clean e-CIB record
- ▶ In line with the Credit Policy of Banks, should be above average borrower. (May be reviewed later in light of the feedback from selected banks)

Loan Limit and Tenure of the Guaranteed Amount:

The loans under the scheme shall cater both the short and medium term loans of up to 3 (three) years for both working capital and medium-term capital needs up to a maximum amount of Rs.5.0 (five) million for a single borrower to be guaranteed. However, the loan limit to the subsistence farmers under the Scheme will not exceed Rs 0.5 million.

Payment of Claims under the Guarantee Scheme:

The Scheme shall pay 50% of the claim to the lender when the loan is categorized as doubtful and the remaining 50% at the time of loss. However, this re-imbursement shall not obviate the lending institutions from the right of recovery of the defaulted amount. The banks shall continue with their regular procedure for recovery of loan and status shall be reported to the CGO on yearly basis. As soon as the loan is recovered, the PFI shall be obliged to return the proportionate share of CGS to the Guarantee Fund. A recovery from a delinquent borrower after reimbursement of guarantee claim by SBP is to be treated as recovery of principal and costs incurred on recovery efforts is not to be passed on to the Guarantee Scheme. To ensure that due diligence was carried out by the PFIs at the time of disbursement, all claims qualifying for payment would be inspected by Banking Inspection Department of SBP.

Monitoring of the Guaranteed Portfolio:

To ensure compliance with the objectives of the guarantee fund and avoid adverse selection problems on part of banks, the Banking Inspection Department of State Bank will review the guaranteed loan portfolios of PFIs during their regular and special inspection of the PFIs.

Interpretation:

If any question arises in regard to the interpretation of any of the provisions of the Scheme or of any directions or instructions or clarifications given in connection therewith, the decision of the SBP shall be final.
