Task Force for the Design, Implementation and Evaluation of Public Credit Guarantee Schemes for Small and Medium Enterprises

Principles

(for Public Credit Guarantee Schemes for SMEs)

CONSULTATIVE DOCUMENT

WORLD BANK GROUP

Strengthening Financial Sectors

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I. Purpose and Objectives of the Principles

1. Financial inclusion, particularly for small and medium enterprises (SMEs), is widely recognized as one of the key drivers of economic growth and job creation in all economies. SME credit markets are notoriously characterized by market failures and imperfections including information asymmetries, inadequacy or lack of recognized collateral, high transaction costs of small-scale lending and perception of high risk. In order to address these market failures and imperfections, many governments intervene in SME credit markets in various forms.

2. A common form of intervention is represented by credit guarantee schemes (CGSs). A CGS provides third-party credit risk mitigation to lenders with the objective of increasing access to credit for SMEs. This is through the absorption of a portion of the lender's losses on the loans made to SMEs in case of default, in return for a fee. The popularity of CGSs is partly due to the fact that they typically combine a subsidy element with market-based arrangements for credit allocation, therefore involving less room for distortions in credit markets than more direct forms of intervention such as state-owned banks.

3. CGSs can potentially play a more important role, especially in countries with weak institutional environments, by improving the information available on SME borrowers in coordination with credit registries, and by building the credit origination and risk management capacity of lenders (e.g. through technical assistance for the setup of SME units). Moreover, CGSs can be leveraged to provide countercyclical financing to SMEs during a downward economic cycle, when risk aversion may heighten and a credit crunch is likely to set in.

4. More than half of all countries have a CGS in place and the number is growing. As a result of the global financial crisis as well as of the international community's increasing emphasis on SMEs as an engine for growth and employment, there has been renewed interest from governments in CGSs. A CGS can be a critical policy instrument for easing financing constraints for SMEs thus contributing to sustainable economic development and job creation.

5. For that purpose, it is important to ensure that CGSs are properly designed and operated in a way to achieve both outreach and additionality in a financially sustainable way. Outreach refers to the scale of the CGS, as measured by the number of guarantees issued to eligible SMEs and the amount of outstanding guarantees. In principle, the greater the outreach, the stronger is the impact of the CGS on the SME segment. However, the impact of the CGS on the supply of credit to the SME segment will also depend on whether guarantees are solely or mainly extended to SMEs that are credit constrained either in terms of access or in terms of unfavorable conditions such as cost and maturity (financial additionality). It is also important that there is ultimately an improvement in the overall economy as a result of increased access and availability of capital for SMEs (economic additionality). Finally, reaching SMEs that are credit constrained involves risk-taking and financial losses. Public CGSs are not designed or expected to make a profit. However, they should still be financially sustainable in the long-term, i.e. able to contain losses and ensure

an adequate equity base *vis-à-vis* its expected liabilities, through sufficient funding, effective risk management and sound operational rules.

6. To that end, the World Bank Group and FIRST Initiative convened and provided secretariat support to a Task Force representing international associations of both CGSs and lenders to develop a set of Principles for the design, implementation, and evaluation of public CGSs for SMEs.

Objective

7. The objective of the Principles is to provide a generally accepted set of good practices, which can represent a global reference for the design, execution and evaluation of public CGSs. The Principles propose appropriate governance and risk management arrangements as well as operational conduct rules for CGSs, which can lead to improved outreach and additionality *cum* financial sustainability. The Principles are drawn from existing CGSs' sound practices as implemented in a number of jurisdictions. Distilling these practices into internationally accepted Principles is expected to improve their performance while at the same time advancing knowledge and awareness of CGSs and of their role in the economy. The Principles are also expected to guide CGSs, including newly established ones, to develop, review or strengthen their organization, operations and risk management practices.

8. To ensure a sound application of the Principles, a constructive and collaborative response from the recipient countries, including the financial sector, is essential. The Task Force is of the view that the Principles, if properly implemented, will help financial sector development and ultimately improve access to credit for SMEs.

Scope of application

9. The Principles are developed for the purpose of being applied to public CGSs for SMEs. Public CGSs for SMEs are institutions created by the government, which retains *de jure* or *de facto* control as defined in relevant home country laws, to provide credit guarantees to lenders to ease access to credit for SMEs operating in its jurisdiction. Target SMEs may operate in any sector, including agriculture. Public CGSs can be national, regional or local in scope. The Principles are also intended to be applied to two-tier CGSs, where there is a system of CGSs operating locally which reinsure part of their risk to a central counter- CGS. The Principles, however, include a number of good practices, which can be applied to other forms of CGSs, including international, cross-border CGSs, donor-funded CGSs and privately-owned CGSs.

Nature

10. The Principles are a set of good practices that public CGSs are implementing or expect to implement on a voluntary basis. Given their intended general nature, the Principles are envisioned to be applicable in all jurisdictions, regardless of their relative level of economic and financial sector development.

11. The Principles are expected to guide country authorities in the design, implementation and evaluation of existing and new CGSs, and to help inform any related policy, legal and institutional reform. At any rate, the Principles are subject and subsidiary to existing home country laws and regulations. They complement rather than substitute other relevant international standards and codes as applicable to CGSs.

Preconditions for effective design, implementation and evaluation of CGSs

12. CGSs are established to address market failures, which prevent SMEs from accessing credit in the quantity and quality that is socially desirable. Hence, they are not an end in itself but rather a means to solve a problem. It is, therefore, essential that the market failures be comprehensively analyzed to identify and define the problems to be addressed, and determine whether there is evidence that government intervention through a CGS is justified. Governments are nonetheless encouraged to pursue all the necessary legal, regulatory and institutional reforms to ameliorate the enabling environment for access to credit for SMEs.

13. Even if the analysis of market failures suggests that intervention through a CGS is justified in principle, an effective CGS requires a number of external elements or preconditions, which may have a direct impact on the achievement of its policy objectives. These preconditions comprise: (i) a system of business laws, including corporate, bankruptcy, contract, collateral, consumer protection and private property laws, which provide an acceptable degree of enforcement and a mechanism for a fair resolution of disputes; (ii) a sufficiently efficient and independent judiciary, and reasonably well regulated legal, accounting and auditing professions; (iii) a comprehensive and well-defined set of accounting standards and rules; and (iv) a sound financial system able to originate and manage credit effectively.

14. These preconditions are normally outside the control or influence of CGSs. Where CGSs have concerns that the preconditions could impact their effectiveness, they should make the government and relevant stakeholders aware of them and their actual or potential negative repercussions for the achievement of the intended policy objectives. CGSs should also, as part of their normal business operations, adopt measures to address the effects of such concerns on the effectiveness of their activities.

Outline

15. The Task Force has identified four key areas for the success of public CGSs. Accordingly, the Principles cover the following key dimensions:

A. Legal and regulatory framework;

B. Corporate governance and risk management;

C. Operational framework; and

D. Monitoring and evaluation.

16. Good practices in the first area are intended to provide the foundations for a CGS, i.e. its legal basis and the regulatory and supervisory framework. A sound corporate governance framework and risk management infrastructure, set out in the second area, is a critical building block for an effectively designed and independently executed strategy aligned with the CGS's stated mandate and policy objectives, while ensuring proper monitoring of both financial and non-financial risks. A clear operational framework, the subject of the third area covered by the Principles, provides CGSs with a course of action *vis-à-vis* essential working parameters. Finally, good practices identified in the fourth area show how CGSs are expected to report on their performance and, more importantly, evaluate the achievement of their policy objectives.

Implementation and review

17. The Task Force acknowledges that implementation of the Principles may be challenging in some countries, requiring an appropriate transitional period, especially for newly established CGSs. Accordingly, the Principles are formulated broadly enough to accommodate different legal, regulatory and institutional settings in various jurisdictions.

18. The Task Force also acknowledges that several aspects of the Principles could benefit from further study and work. The evolving nature of the financial system, of which CGSs are an important component in many jurisdictions, as well as further experiences of public CGSs are likely to produce the need for re-examination of some aspects of the Principles over time. Continuing coordination and consultation at the international level is also desirable for other issues of common interest to CGSs.

19. To facilitate this, the Task Force has agreed to consider its evolution into a permanent Standing Group of CGSs, with terms of reference to be developed and decided among its members. This Standing Group would be able to review periodically the Principles, as appropriate, as well as provide member organizations with a continuing forum for exchanging ideas and views. The Standing Group could also examine ways through which aggregated information on CGSs around the world could be periodically collected and made publicly available.

II. The Principles

Principle 1

The CGS should be established as an independent legal entity based on a sound and clearly defined legal and regulatory framework to support the effective implementation of its operations and the achievement of its policy objectives.

Principle 2

The CGS should have adequate funding to achieve its policy objectives, and the sources of funding, including any reliance on explicit and implicit subsidies, should be transparent and publicly disclosed.

Principle 3

The legal and regulatory framework should promote mixed ownership of the CGS, ensuring equitable treatment of minority shareholders.

Principle 4

The CGS should be independently and effectively supervised based on risk-proportionate regulation scaled by the products and services offered.

Principle 5

The CGS should have a clearly defined mandate supported by strategies and operational goals consistent with its policy objectives.

Principle 6

The CGS should have a sound corporate governance structure, with an independent and competent board of directors appointed according to clearly defined criteria.

Principle 7

The CGS should have a sound internal control framework to safeguard the integrity and efficiency of its governance and operations.

Principle 8

The CGS should have an effective and comprehensive enterprise risk management framework which identifies, assesses and manages the risks related to its operations.

Principle 9

The CGS should adopt clearly defined and transparent eligibility and qualification criteria for SMEs, lenders and credit instruments.

Principle 10

The CGS's guarantee delivery approach should appropriately reflect a trade-off between outreach, additionality and financial sustainability, taking into account the level of financial sector development of the country.

Principle 11

The guarantees issued by the CGS should be partial, providing the right incentives for SME borrowers and lenders, and designed to ensure compliance with the relevant prudential requirements for lenders.

Principle 12

The CGS should adopt a transparent and consistent risk-based pricing policy to ensure that the guarantee program is financially sustainable and attractive for both SMEs and lenders.

Principle 13

The claim management process should be efficient, clearly documented and transparent, providing incentives for loan loss recovery, and aligned with the home country's legal and regulatory framework.

Principle 14

The CGS should be subject to rigorous financial reporting requirements and have its financial statements externally audited.

Principle 15

The CGS should periodically and publicly disclose non-financial information related to its operations.

Principle 16

The performance of the CGS, in particular its outreach, additionality and financial sustainability, should be systematically and periodically evaluated and the findings publicly disclosed.

III. Discussion of the Principles

20. Public CGSs either have implemented or intend to implement the following Principles on a voluntary basis and subject to home country laws, regulations, requirements and obligations. This paragraph is an integral part of the Principles, which should be read in conjunction with their related Explanatory Notes.

A. Legal and Regulatory Framework

Principle 1: The CGS should be established as an independent legal entity based on a sound and clearly defined legal and regulatory framework to support the effective implementation of its operations and the achievement of its policy objectives.

Explanatory Notes

21. The CGS should be established as an independent legal entity, allowing the government to retain ownership and/or control but still enabling it to run the CGS efficiently and on a sustainable basis. A clearly defined legal and regulatory framework for the CGS should have its basis in appropriate and specific legislation. The establishment of the CGS should be authorized under a domestic law or decree, either under corporate or banking legislation, or institution-specific legislation. A sound legal and regulatory framework provides the institutional foundations of the CGS, enhancing its credibility and reputation.

22. The legal and regulatory framework should clarify the ownership policy of the government and any general terms and conditions that apply to the government's investment, and the manner in which the government will exercise its ownership, including who is responsible and accountable for representing the government. The legal and regulatory framework should set clear boundaries and define the relationship between the government as shareholder and the CGS's board and management, separating legitimate government control and oversight from day-to-day operations, ensuring the CGS's managerial autonomy and accountability necessary in decision-making. A sound legal and regulatory framework facilitates the formulation and implementation of an appropriate strategy to achieve the CGS's stated policy objectives. The legal framework should specify the sources of funding of the CGS.

23. The Task Force recognizes that governments may choose to operate CGSs through development finance institutions. In these cases, CGSs should be financially and operationally independent and apply the Principles related to the operational framework (Principles 9 - 13). On the other hand, pay-as-you-go CGSs based on annual budgetary subventions and run as programs by government agencies should be discouraged.

Principle 2: The CGS should have adequate funding to achieve its policy objectives, and the sources of funding, including any reliance on explicit and implicit subsidies, should be transparent and publicly disclosed.

Explanatory Notes

24. The CGS should have adequate capital and government financial support to ensure an effective implementation of its operations and achieve meaningful outreach and additionality with financial sustainability. Setting up a CGS with inadequate financial resources can result in limited developmental impact and lack of financial sustainability, seriously undermining the confidence of lenders and endangering the attainment of its policy objectives. The adequacy of funding should be determined by the policy objectives that the CGS intends to achieve and the volume of business it needs to generate in order to remain current on its financial obligations while ensuring long-term financial sustainability.

25. There should be clear and publicly disclosed rules, procedures or arrangements which clarify the responsibilities of the government or ownership entity for providing the CGS's initial capital as well as any commitment to provide additional capital and/or subsidies during the course of operations. Sources of funding should be clearly identified. The CGS should be primarily funded out of equity endowments, which can be complemented by long-term concessionary loans from government sources or multilateral and bilateral institutions. The CGS should not borrow from public and private debt markets.

26. To mitigate fiscal risk for the government, limits on budget appropriations, subsidies, and guarantees should be put in place in the relevant legislation. Such limits should be set to accommodate the CGS's policy goals and be fully consistent with the fiscal resources provided in the government accounts. Funding usage and existing limits should be reviewed periodically and revised as appropriate under a fully transparent process, and be audited by the Supreme Audit Institution or any other mandated institution, according to home country laws.

Principle 3: The legal and regulatory framework should promote mixed ownership of the CGS, ensuring equitable treatment of minority shareholders.

Explanatory Notes

27. Mixed ownership results when a government or ownership entity chooses a strategic private sector partner to invest in a CGS to gain access to commercial and industry experience, or establishes a new CGS in partnership with the private sector. Voluntary, minority participation of lenders and/or SMEs provides a source of finance for the CGS, and may play an important role in advancing knowledge of the target markets as well as in introducing good governance practices for the efficient management of the CGS. Mixed ownership has the further advantage of reducing moral hazard on the part of the CGS, lenders and SME borrowers through introducing peer pressure, shared responsibility and transparency in the decision-making process. The legal and regulatory framework

establishing the CGS should encourage but not force private sector participation in the ownership structure of the CGS.

28. Mixed ownership, however, poses specific governance challenges. Because the state typically retains a large ownership share, the government or ownership entity can choose all board members and make major decisions unilaterally. Even when the state's direct ownership share is smaller, the state may retain a high degree of control through government-linked investors, shares held through other state-owned enterprises, or special legal rights known as "golden shares". If the government or ownership entity exploits its control rights and pursues its interests to the disadvantage of other shareholders, the potential benefits of bringing in other shareholders would be undermined. Equitable treatment of shareholders is thus crucial to achieving the benefits that mixed ownership could bring. The legal and regulatory framework should assign clear responsibility for protecting the basic rights of minority shareholders and promoting active shareholder participation in the governance and decision making process of the CGS.

Principle 4: The CGS should be independently and effectively supervised based on risk-proportionate regulation scaled by the products and services offered.

Explanatory Notes

29. Supervisory accountabilities should be defined in the relevant legal and regulatory framework, and clearly separated from ownership and management. An effective system of supervision should assign clear responsibilities and objectives for the agency involved in the supervision of the CGS. The supervisor should be empowered in a monitoring role to ensure that the CGS is run as efficiently as possible while minimizing the risk to the taxpayers of any unexpected and unbudgeted costs for the losses that may occur in the normal course of business operations. The supervisor should be empowered with the legal means to enforce prudential standards and secure corrective measures when necessary. The supervisor should be required to formally raise objections and seek administrative injunctions of inadmissible activities should such activities be identified. These objections should be made public by the supervisor in its annual reports or in a special interim report as appropriate. The legal powers of the supervisor should be reinforced with public disclosure responsibilities.

30. To benefit from economies of scale and reduce the overall costs of independent supervision, supervisory powers should be vested in one entity. Normally, the country authorities choose to empower the financial sector supervisor with responsibility for the supervision of the CGS. If this approach is adopted, it is important that the supervisor have adequate funding and that the culture of prudential supervision be consistent with the culture used to supervise commercial financial institutions.

31. Supervision should be calibrated according to the nature and risks of the products and services provided by the CGS. The supervisor should have at a minimum the responsibility to monitor the CGS's activities based on the CGS's mission statement and the specific lines of business its charter legislation empowers it to conduct based on a sound corporate

governance framework and adequate risk management systems. Moreover, the supervisor should determine that the CGS continuously satisfies minimum prudential capital standards (or maximum leverage). These capital standards should be set in the CGS's chartering legislation or by regulation issued by the empowered supervisor. The prudential capital standards should be established to provide an adequate buffer to protect against unscheduled needs for fiscal support. Minimum prudential capital standards should be designed to reflect the policy objectives of the CGS and the riskiness of the business environment in which the CGS operates. Finally, the supervisor should determine that the CGS has adequate policies and processes for the early identification and management of problem assets, and the maintenance of adequate provisions and reserves.

B. Corporate Governance and Risk Management

Principle 5: The CGS should have a clearly defined mandate supported by strategies and operational goals consistent with its policy objectives.

Explanatory Notes

32. Clearly stating and communicating the mandate of the CGS is necessary for defining accountability, determining the scope of its activities, and forming the basis for more specific targets for its operations. The mandate should be set in the relevant legislation creating the CGS and include at a minimum the target SMEs and the main line(s) of business of the CGS. In addition to the provision of credit guarantees, the mandate may encompass ancillary services such as technical assistance, provision of information, training and counseling. The mandate should also specify a desired level of efficiency for the CGS, which defines goals and/or constraints on financial sustainability. The mandate should be broad enough to ensure take up and accommodate cyclical developments in the target SME sectors. However, a CGS set up for development purposes should not in principle engage in a countercyclical role with its own resources. This would be better achieved through extraordinary measures, such as a counter-CGS or additional funding provided by the government, which may be implemented through the CGS based on specific contractual arrangements. The mandate should be subject to periodic reviews through an explicit and transparent mechanism in order to assess its continuing validity.

33. Based on its mandate, the CGS should develop coherent strategies and specific programs for different target sectors and groups. Acknowledging that different SME target sectors and groups may require different operational support, the CGS should develop tailored strategies, including an effective communication strategy. The process of developing a strategy should involve management, the board and the government or ownership entity. Management should be responsible for developing and executing the strategy while the board should be responsible for approving the strategy and monitoring its implementation. The government or ownership entity should be responsible for monitoring the CGS's performance and its adherence to its strategy and other commitments, in line with the general objectives that the government has defined for the CGS. The strategies should include specific operational goals to ensure the CGS's

performance and financial sustainability, and to meet its policy objectives. Operational goals should be clear and realistic and measured against key performance indicators and targets.

Principle 6: The CGS should have a sound corporate governance structure, with an independent and competent board of directors appointed according to clearly defined criteria.

Explanatory Notes

34. The CGS's corporate governance framework should ensure that operational management is conducted on an independent basis so that business decisions are taken based on economic and financial considerations in line with the mandate and policy objectives, free of political influence and interference. The corporate governance framework of the CGS should be set out in the legal framework, charter or other constitutive document. It should ensure appropriate division of roles and responsibilities, especially among the government or ownership entity, the supervisor, the board and the management of the CGS.

35. Political influence and interference is one of the major impediments for an effectively functioning CGS. This is typically a consequence of the lack of independence of the board of directors and senior management of the CGS. Political intervention can be limited by ensuring a clear process for the appointment of board members. The government or ownership entity should adopt a structured and transparent board appointment process that adheres to explicit policies and procedures and seeks to ensure the ability of the board to exercise its responsibilities in an independent manner. The board appointment process should be made explicit in the relevant legal and regulatory framework of the CGS. Transparency in the nomination process should ensure technical expertise consistent with the business operations of the CGS. A clear policy setting minimum standards of competency for board members should be adopted.

36. Board members should serve a fixed term, act in the best interest of the CGS and face no conflicts of interest in such actions. They should act with integrity and be held accountable for their actions, while being indemnified to minimize potential personal liabilities incurred in that capacity. More generally, the board should include an independent and unaffiliated member(s) from the private sector. Where a mixed ownership model is adopted, minority shareholders should be adequately empowered either through participation in the nomination process or the appointment of a representative(s) on the board.

Principle 7: The CGS should have a sound internal control framework to safeguard the integrity and efficiency of its governance and operations.

Explanatory Notes

37. The CGS should have a strong system of internal controls proportionate to its size and complexity. Effective internal controls allow management to know what is happening in the organization and whether their instructions are being carried out. The CGS's management should design internal control procedures with several purposes in mind: to

safeguard assets against unauthorized use or disposition, to maintain proper accounting records, and to ensure the reliability of financial and non-financial information. Procedures should ensure that business processes and other activities are conducted properly, mitigate the potential for misconduct, and detect any misconduct that does occur. The board, either directly or through a board committee, should assume responsibility for periodically reviewing the system of internal controls established by the management.

38. The CGS should have an internal audit and compliance function. To ensure objectivity and ability to provide key information to the board, the internal audit and compliance function should report directly to the board, or the audit or compliance committee. The internal audit and compliance function should place particular emphasis on monitoring the CGS's control systems, and evaluate risk exposures related to the CGS's governance, operations, and information systems. In addition, the internal audit and compliance function should typically be able to carry out ad hoc investigations at the request of the board, and/or audit or compliance committee. The internal audit and compliance function should have the relevant power to ensure that issues raised in investigations will be addressed, and the board, and/or audit or compliance committee, should ensure that the internal audit and compliance function has adequate resources to carry out all its tasks.

Principle 8: The CGS should have an effective and comprehensive enterprise risk management framework which identifies, assesses and manages the risks related to its operations.

Explanatory Notes

39. The ability of a CGS to identify, measure, monitor and control the risks it faces as well as to determine that it holds adequate capital against those risks is a critical component of the overall corporate governance framework. Adherence to high standards in risk management with sound operational controls and systems is an essential determinant of the CGS's performance and its ability to execute its mandate. The CGS should adopt a sound enterprise risk management framework as part of its internal control environment. It should include reliable and accurate information, including that provided by lenders, SME borrowers and third parties, and timely reporting systems to enable adequate monitoring and management of relevant risks within acceptable parameters and levels adopted formally by the board. The enterprise risk management framework should be approved by the board and subject to periodic reviews in order to assess its continuing relevance. At a minimum, the enterprise risk management framework should identify, assess and manage credit risk, liquidity and market risk, as well as operational risk.

40. Credit risk is the main risk faced by a CGS. While credit risk management practices may differ depending on the specific nature of the CGS and its delivery method, a comprehensive credit risk management framework should be in place, with clearly defined responsibilities and accountabilities, including *vis-à-vis* lenders. The measurement and management of credit risk should rely on quantitative and qualitative techniques as appropriate. An effective credit risk management should establish and enforce a set of relevant exposure limits (e.g. by single borrower or group of connected parties, sub-sector,

geographical area etc.) as well as use any appropriate technique or instrument available, such as counter-guarantees, to mitigate concentration risk. It should also encompass sound guarantee evaluation policies and practices. Finally, it should ideally include a proper system to identify environmental, social and corporate governance risks associated with the CGS's guarantee business in order to nurture green and socially responsible business development by both SMEs and lenders.

41. A second main risk confronted by a CGS is liquidity and market risk. It is important that the CGS develops an effective liquidity and market risk management framework to ensure that it is able to meet claims and hedge against adverse movements in market prices. Reliable governance arrangements, management information systems, analysis of liquidity requirements, and contingency planning (for example, a concessional stand-by line of credit from the government) are crucial elements of strong liquidity and market risk management. The CGS should also have a transparent investment policy that clearly sets out an investment framework consistent with the mandate and strategic objectives of the CGS, the approved risk profile and the monitoring procedures. The investment policy should be guided by appropriate portfolio management criteria aimed at minimizing risks. The investment policy should also define permissible asset classes and provide guidance on concentration risk *vis-à-vis* individual exposures, liquidity profile, and sectoral and geographical concentration.

42. A third main risk faced by a CGS is operational risk. This refers to the risk of a loss from failures in the CGS's systems and procedures or events outside the control of the organization. The main operational risks are due to incompetence and fraud, business continuity risk, process risk, technology risk, reputational risk, and legal risk. To assess and control operational risks, the CGS should establish and document a framework that identifies lines of responsibility, segregation of duties, and reliable control mechanisms. Codes of conduct and recruitment policies are important to ensure the professional and ethical behavior of staff involved in the CGS's operations. To ensure that the CGS can continue its operations in case of a technology breakdown or natural disaster, business resumption planning should be an important part of the operational risk framework.

C. Operational Framework

Principle 9: The CGS should adopt clearly defined and transparent eligibility and qualification criteria for SMEs, lenders and credit instruments.

Explanatory Notes

43. The CGS should adopt clear eligibility and qualification criteria to guide its operations in line with its mandate. These criteria should be publicly communicated and subject to periodic reviews. First, the SME target sectors and groups should be clearly defined in the policies or other relevant operational documents of the CGS. Typical eligibility criteria include size, sub-sector and the age of firms. In general, these eligibility criteria are combined. Size is typically defined in terms of maximum number of employees, value of assets and/or sales. Many CGSs have also a number of different windows or separately

designed programs dedicated to sub-classes of firms such as start-ups, exporters and high-tech firms. There are also CGSs that directly or indirectly target specific ethnic groups, women or youth, where the policy aim is to encourage entrepreneurship in these segments of the population. The CGS may adopt a negative list of ineligible SMEs, for example based on their credit profile and repayment reputation, and explicitly exclude some sub-sectors from its scope of operations. The CGS should also define qualification criteria for lenders based, for example, on their interest and capacity in serving SMEs, level of nonperforming SME loans, and risk management capabilities.

44. In addition to determining which SMEs are to benefit from guarantees and which lenders qualify for the usage of the guarantees, the CGS should clarify the type of credit instrument targeted. Credit instruments covered by a CGS typically include working capital and/or investment finance. The CGS should provide guarantees for both purposes. Whereas working capital finance may be important for sustaining jobs in SMEs that are vulnerable to insolvency due to insufficient short-term credit, investment finance is essential for job creation and long-term economic growth. The CGS should cover the principal loan amount of the underlying credit instrument and to a limited extent the unpaid interest. The CGS should not give priority to the refinancing of existing guaranteed loans, unless exceptional circumstances spelled out in the operational documents justify this kind of intervention. On the other hand, the provision of guarantees for rescheduled and/or restructured loans may be an acceptable practice if additional funds are being offered based on the prospects of the SME borrower, while the lender retains its share of credit risk.

Principle 10: The CGS's guarantee delivery approach should appropriately reflect a trade-off between outreach, additionality and financial sustainability, taking into account the level of financial sector development of the country.

Explanatory Notes

45. The modalities of extension of guarantees, which determine the relationship between the CGS and the SME borrower, should be driven by the ultimate objectives of the CGS. Two main methods of delivery are generally observed: the individual approach and the portfolio approach. In the individual approach, guarantees are provided on a loan-by-loan basis. In most CGSs, the SME borrower approaches a lender, which reviews the project and makes the loan conditional upon a guarantee. Less frequently, the CGS issues an advance guarantee approval to the SME borrower, which can then use it to negotiate the loan with the lender. In either case, a direct relationship between the CGS and the SME borrower exists, since the former investigates every single loan application and selects those to guarantee. This should reduce the probability of moral hazard on the part of the lender during the appraisal process and ensure that guaranteed SME borrowers indeed belong to the targeted sectors and groups. On the other hand, the individual approach may involve lower outreach and higher operating costs, which may negatively impact the overall efficiency of the CGS and its financial sustainability.

46. In the portfolio approach, lenders are entitled to attach guarantees to loans within eligible categories clearly specified in the contractual agreements between the CGS and the

lender, without prior consultation of the CGS. In the portfolio approach there is, therefore, no direct relationship between the CGS and the SME borrower. The portfolio approach may allow the CGS to reach a larger number of SME borrowers, possibly establishing a good repayment reputation for future lending relationships. Moreover, the economies of scale arising from increased business volumes can allow more cost-effective operations for the CGS. However, financial additionality may be lower than under the individual approach if a large proportion of guarantees are awarded by lenders to SME borrowers that could have qualified for non-guaranteed loans. Finally, default rates may be higher due to the risk of moral hazard on the part of the lender during the appraisal process.

47. The choice of the delivery approach should involve an analysis of the trade-off between outreach, additionality and financial sustainability. Whereas the individual approach may imply high costs and low outreach, the portfolio approach may make it harder that all guaranteed SME borrowers belong to the target groups and sectors. The CGS should ideally combine both approaches, taking into account the degree of development and sophistication of the overall financial sector and individual financial institutions. If a certain type of SME, for example early-stage SMEs or those owned by women, is to be promoted, irrespective of the specific project presented, the portfolio approach may be used. Other SMEs would be selected individually. Alternatively, loans up to a certain amount may qualify for portfolio guarantees, whereas large loans may be assessed by the CGS on an individual basis. However, in countries where market failures and imperfections in SME credit markets are pervasive, the focus should be on the individual approach. In such circumstances, the individual approach may reduce information asymmetries and improve the lenders' perception of high risk of the SME segment, while establishing a trusted relationship between the CGS and the lenders.

Principle 11: The guarantees issued by the CGS should be partial, providing the right incentives for SME borrowers and lenders, and designed to ensure compliance with the relevant prudential requirements for lenders.

Explanatory Notes

48. In order to avoid moral hazard on the part of both lenders and SMEs, it is important that credit risk be shared appropriately among the CGS, lenders and SMEs to ensure that the right incentives are in place so that default and claim rates are kept as low as possible. The CGS can distribute risk to the lenders by means of the guarantee coverage ratio, usually expressed as a percentage of the underlying loan exposure. The guarantee coverage ratio should be high enough to induce lenders to participate. At the same time, it should be crafted for the lenders to assume a meaningful share of credit risk. In principle, the guarantee coverage ratio should not be lower than 50 percent. The guarantee coverage ratio should be clearly indicated in the contractual agreements between the CGS and the lender. These agreements should also clarify whether the losses are shared on a *pari passu* basis between the CGS and the lender, or whether the CGS covers the first loss.

49. The appropriate guarantee coverage ratio should depend on the SME targeted sectors and groups. For example, higher coverage may be granted to SMEs operating in sectors with

higher potential for job creation and/or preservation, or for early stage firms. The appropriate coverage ratio should also be a function of the delivery approach employed by the CGS. Under the portfolio approach, the guarantee coverage ratio should be lower than under the individual approach since the appraisal of the SME borrowers is entirely conducted by the lender. The appropriate guarantee coverage ratio should finally reflect the level of financial sector development of the country. Higher coverage may be established in less developed jurisdictions. The CGS should be able to adjust its guarantee coverage ratio to reflect its credit loss history and external market developments.

50. Risk sharing is also important to avoid moral hazard on the part of the SME borrowers, who should, therefore, retain part of the risk and demonstrate commitment to repay by supplying adequate collateral. The CGS should ensure, however, that collateral requirements are not excessive, since this would defeat the purpose of the guarantee, and work with the lender to mitigate this issue.

51. The guarantee extended by the CGS should include terms and conditions, clearly specified in the contractual agreements with the lender, which are compliant with the relevant prudential regulation of credit risk mitigation techniques as applicable to the lender. This is important to ensure that the guarantee issued by the CGS can provide capital relief to the lender for the proportion of the underlying loan exposure covered by the guarantee. In most jurisdictions, the prudential regulatory framework for lenders provides for a favorable treatment of exposures to the government for the purpose of calculating prudential capital requirements. This implies that the guaranteed loans will benefit from lower risk weight or equivalent probability of default. However, the guarantee issued by the CGS should meet certain minimum legal requirements in terms of seniority, revocability and effectiveness as set by the financial regulator. The guarantee issued by the CGS should be in compliance with these minimum requirements to maximize the incentives for lenders to participate in the CGS. The guarantee issued by the CGS should also be in compliance with the prudential rules for loan loss classification and loan loss provisioning requirements for collateralized assets as applicable to the lender, thus providing a further incentive for lenders to use it.

Principle 12: The CGS should adopt a transparent and consistent risk-based pricing policy to ensure that the guarantee program is financially sustainable and attractive for both SMEs and lenders.

Explanatory Notes

52. The CGS should charge fees for the guarantees it provides based on the riskiness of the guarantee provided, as reflected in the combination of guarantee coverage ratio, exposure at default, and loss given default. This is important to signal that guarantees have a value and that the CGS operates under market conditions. The pricing policy should be transparent and codified in the CGS's relevant operational documents.

53. When determining the size and the structure of the fees the CGS should strike a balance between the outreach of the guarantee program and its financial sustainability. Fees

combined with the income that the CGS derives from its investment activities, together with any pre-agreed level of operational subsidy through government budgetary subventions, should cover both the cost of operations and the expected cost of credit risk (or claims). Fees should always be levied on the amount guaranteed. The CGS should be able to adjust its pricing policy based on its credit loss history and market developments.

Principle 13: The claim management process should be efficient, clearly documented and transparent, providing incentives for loan loss recovery, and aligned with the home country's legal and regulatory framework.

Explanatory Notes

54. A timely, efficient and transparent procedure for triggering claims is important to gain the confidence of lenders. The CGS should articulate in the contractual agreements with the lender the precise circumstances under which a claim can be made. Many CGSs have a minimum period after loan disbursement before a claim can be entered. The trigger conditions for claims should specify a maximum period after a missed payment(s) and not be conditional upon initiating legal action against the SME borrower. Lenders, however, should proactively explore alternative solutions, including rescheduling, to receive payment from the SME borrower.

55. There should be a clear and transparent process to ensure that guarantee payments are settled in a timely manner to avoid costly disputes. A CGS's credibility is largely dependent on how claims are handled once they have been submitted. Conditions under which a claim is acceptable, including its timely verification, should be clearly stated in the contractual agreements with the lender, and refusal of a claim should be accompanied by a detailed written explanation. The maximum amount of unpaid interest covered by the guarantee should also be clearly specified. There should be a time limit for the settlement of claims.

56. There should also be an unambiguous and efficient post-claim loss recovery process. This should be detailed in the contractual agreements with the lender. Loss-given-default rates for both the CGS and the lender can be reduced by pursuing SME borrowers that have defaulted on the guaranteed loans after claims have been paid. Since there may be economies of scale and scope in concentrating recovery activities in one organization, there should be a clear *ex ante* division of labor between the CGS and the lender, with responsibilities clearly delineated based on expertise and resources. Should the CGS take over responsibility for debt recovery, it is important that the subrogation of the loan be documented and legally enforceable. The debt recovery process should be consistent with the home country's legal and regulatory framework.

D. Monitoring and Evaluation

Principle 14: The CGS should be subject to rigorous financial reporting requirements and have its financial statements externally audited.

Explanatory Notes

57. Timely, accurate, and appropriately audited financial statements are an important tool for holding the management of a CGS accountable for its stewardship of the organization. The CGS should produce and disclose financial statements at least on an annual basis, including a balance sheet, cash flow statement, profit and loss statement, statement of changes to equity, and notes. A management commentary should accompany annual financial statements. The financial statements should be prepared in accordance with the home country's accounting standards required for domestic private sector financial enterprises. Using the same reporting standards as private sector enterprises allows the CGS to draw on an established independent body of expertise for organizing and auditing its financial statements, as well as for evaluating their significance.

58. The CGS should have its financial statements externally audited by a professional, certified audit firm. An independent external audit contributes to the credibility of the CGS's financial reporting and provides reasonable assurance to the government or ownership entity, other shareholders and the general public that the financial statements fairly represent, in all material respects, the financial position and performance of the CGS. An external audit also provides the CGS's management with useful insights into the CGS's main risk areas related to the internal controls and the reporting process.

Principle 15: The CGS should periodically and publicly disclose non-financial information related to its operations.

Explanatory Notes

59. The CGS should publicly report non-financial information at least on an annual basis. Such disclosure, often qualitative in nature, should give stakeholders key insights into the workings of the CGS and its prospects, as well as its relationship with the government or ownership entity. Non-financial reporting should be linked to the policy objectives of the CGS. At the minimum, the following non-financial information should be disclosed: (i) social and economic commitments made; (ii) social and economic outcomes; and (iii) any other material engagement into which the CGS has entered as a result of its status as a government-owned institution.

60. The CGS should disclose information related to its corporate governance structure, including board committees, and relevant policies. Like private sector companies, the CGS should also disclose aggregate and individual pay to board members and the chief executive officer, and the policy on which this pay is based. Board members' background, current employment, other directorships, and board and committee attendance should also be disclosed. The information should clarify which board members are serving as

government officials, which are primarily from the public sector, and which are from the private sector. Finally, where a mixed ownership model is adopted, the CGS should disclose ownership structure and rights of minority shareholders, and any special right retained by the government or ownership entity. Any shareholder agreement, including its terms, between the government and private shareholders should also be made public.

Principle 16: The performance of the CGS, in particular its outreach, additionality and financial sustainability, should be systematically and periodically evaluated and the findings publicly disclosed.

61. A comprehensive evaluation of the CGS's performance is necessary to account for the usage of public resources, to measure the achievement of its policy objectives and to improve its operations. The CGS should establish a sound mechanism for comprehensively and systematically assessing the performance of its operations. The performance evaluation framework should be linked with the internal control environment to generate relevant data and information. The performance of the CGS should be evaluated at least every three to five years. The methodology of the performance assessment should be transparent and the findings publicly disclosed.

62. The performance of the CGS should be measured and evaluated along the dimensions of outreach, additionality and financial sustainability. Outreach refers to the capacity of the CGS to meet the demand for guaranteed loans by SMEs. Outreach should be measured at a minimum by the number of guarantees issued to eligible SMEs and the amount of outstanding guarantees. However, the scale of activity of the CGS does not necessarily imply impact of the CGS.

63. The impact of the CGS should be assessed through measurement and evaluation of its financial and economic additionality. Financial additionality refers to incremental credit volumes granted to eligible SMEs as a result of the activities of the CGS. Financial additionality includes also more favorable conditions for eligible SMEs in terms of loan size, pricing and/or maturities, reduced amount of collateral required to obtain credit and faster loan processing time. Economic additionality refers to the economic welfare that the CGS generates as a result of its operations. In particular, it refers to impact of guarantees on employment, investment and ultimately on economic growth. The Task Force acknowledges that evaluating the impact of a CGS is technically challenging due to the difficulties in establishing a counterfactual baseline. Nonetheless, the CGS should assess its financial and economic additionality based on existing, widely adopted methodologies, ideally in partnership with academic and research organizations.

64. Finally, the performance evaluation framework of the CGS should include an assessment of its financial sustainability. Financial sustainability refers to the CGS' capacity to contain losses while maintaining an adequate capital base relative to its liabilities on a going concern basis. Financial sustainability indicates the degree of reliance on public support in the operations of the CGS. It should, therefore, be assessed within a long-term perspective.

IV. Annexes and References

Annex I: Task Force Composition

Secretariat[1]

Chair	**Roberto Rocha**, Senior Advisor, World Bank Group
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