

Macedonian Enterprise Development Foundation

Guarantee Funds Study

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A) EXECUTIVE SUMMARY

A.1. GUARANTEE FUND AGAINST RISK OF WAR

The fear among banks of a repetition of the military actions from 2001 or of long-term continued instability in the north-western regions of the country caused a halt in the modest growth of credit supply in these regions and reduced further the disproportionally small presence of these regions in the credit portfolios of the banks. Even though the banks are gradually returning with supplying credits in these regions, this fear inhibits a stronger growth in credit supply and deepens the lag of these regions in regard to the other parts of the country. Because of this, this relatively recent problem should be resolved as a precondition for analyzing and later resolving the other factors that bring about regional disproportions in credit supply.

Because they are not standardized, mechanisms devoted to similar risks are very rare in the world, excluding the MIGA guarantee which anyway is foreseen only for large investors. Thus, there is no registered mechanism in Macedonia for resolving this risk, and there is even no attempt to do this. Therefore, in the case of this risk it is not possible to utilise some existing experiences, but rather it is necessary to design a greenfield solution. Hereby, the following conclusions are deemed to be most relevant for such a scheme:

- The principle of practicality and preciseness requires that the risk clause be linked with an objective fact. During this phase, the best solution seems to be that the guarantee fund should cover the risk from impossibility to execute the collateral, because of some kind of non-functioning of the authorities under conditions of military actions. Such a clause reduces the inevitable subjective element in the assessment when a war risk occurs and may be the first option to be attempted with the bank.
- The guarantee against war risk should be linked initially to the MEDF credit line, both in order to provide a reliable compatibility with the goals, as well as a precaution in its introduction as an innovative mechanism.
- Because of its non-actuarial nature, a price cannot be set for the war risk that would reflect the possible losses, and therefore the price should be: first, sufficient to cover the relatively low costs; second, sufficiently high to secure the justification of its use; third, not so high as to be prohibitive. The best mechanism in all aspects seems to be for the price to be a combination of a one-time non-refundable fee, of around 1%, and an interest rate of around 1% that could be returned if the risk event does not happen.
- Because the covering of war risk does not touch at all upon the business risks, there is no situation of a "moral hazard", and therefore there is no direct reason not to share the risk 100%. However, primarily for providing optimal incentives for the banks in regard to credit management covered by this guarantee mechanism, it is nevertheless recommended that they participate in the risk with not more than 5-10%.
- The target area for the guarantee should be left to the discretion of the banks, because it is the banks that should assess when they need such coverage, and the guarantee scheme is designed in a manner to provide for the responsibility of the banks in requesting the guarantee. Nevertheless, in order to serve in improving access to credit in the "risky regions", it seems advisable to exclude those credits that are only covered by collateral in those regions, i.e. they do not produce economic effects in those regions.
- The guarantee may be linked to the bank's obligation towards MEDF for the relevant credit, and it may also be effectuated through a separate deposit at the bank. The second option does not endanger the credit fund and is easier to administer in comparison to the first option, which on the other hand does not require additional funds but only up to a certain level, up to which the credit fund would not be endangered.
- Depending upon the final version of the risk clause, the guarantee would be considered as activated when the concretely selected combination of conducted military actions and a problem in executing the collateral would occur. However, even though at that moment the credit risk and its management are transferred to MEDF, the intention would be for the bank to continue to perform the technical management of the credit, in the hope that the situation can be corrected and the credit could be performed under normal conditions.

Regardless how carefully the war risk guarantee is designed, it would have no practical effect if the banks decide that it is not sufficient coverage for the credit risks in those areas, or if these areas are still outside of their business policy. This is the most important risk for this guarantee to catch on, and it is somewhat outside of MEDF's reach. Another important risk is insufficient precision in the risk clause, creating numerous practical dilemmas, creating the risk that the banks could call upon the guarantee for covering even the simplest business risks. However, MEDF can somehow control this risk, by careful negotiations and by defining the risk clause.

The guarantee scheme against war risk is a short-term instrument. No "small" instability could last for a longer period of time - it will either disappear or it will erupt. In both cases this means that the guarantee scheme would be terminated. Hereby, in the first case all the engaged funds would be released, while in the second case these funds would be returned, minus the sustained damages from the eventual activation of the guarantee.

A.2. GUARANTEE FUND FOR A LACK OF COLLATERAL

The lack of collateral is a standard factor that weakens the access to bank credits for entrepreneurs. This factor is especially strong in Macedonia, because of the history of high credit losses and the imbalance between credit supply and demand, which increased the demand for collateral. In a situation where both factors are becoming weaker, the demands for collateral also become weaker; however, the lack of collateral will still remain as a factor that needs to be resolved through guarantee mechanisms, as experienced in numerous countries.

The prevalence of this problem is reflected not only in the existence of a large number of guarantee schemes in the world, but also in several such attempts in Macedonia. Nevertheless, until the guarantee fund becomes stronger and confirms itself (as the only really operational scheme at the moment), and until the announced state guarantee fund starts to operate and becomes stronger, it can be said that the demand for such a product will certainly remain unmet.

The prevalence of the problem has also a positive side, by providing standard solutions that have been tested in practice in regard to the individual elements of these guarantee schemes.

- The guarantee scheme would be directed only towards resolving cases where the client represents a good credit risk, except that there is insufficient collateral as required by the bank.
- The risk would be shared between MEDF and the bank. It would be best if the ratio would be somewhere between 60% and 80% for MEDF, in order to achieve a good combination between the collateral and the bank's interest for utilisation and responsibility in their behaviour towards the guaranteed credits.
- The price for the guarantee should be set at a level not very different from the percentage of credit losses of the partner banks, because of the need to cover inevitable losses in the operation of such a guarantee scheme, and hoping that this percentage is not too high, which otherwise would be prohibitive for the users.
- The banks would become key agents in the decision whether a credit requires a guarantee for insufficient collateral, and MEDF would have no active role in the credit analysis, except for a simple examination of the logic of the request and several key parameters (such as: the level and coverage of the overall claims by the bank against that client).

The linking of the guarantee mechanism to the MEDF credit line automatically resolves all the dilemmas regarding the target area and the target groups, and there is no reason for further limitations in that regard.

Similar to the guarantee fund against war risk, this guarantee fund also cannot be expected to have a long-term duration. This kind of guarantee funds can rarely be designed in such a way that all the capacities will be used in a satisfactory manner and the losses would be sustainable. This optimal zone is very tight, and there is a clear risk that the guarantee scheme would either be

depleted by losses that are higher than the accumulated commissions, or that it would die off because of insufficient interest at the banks to use this scheme. It is hoped that this time will be as long as possible, and that during the operation of the guarantee scheme the banks will attain or expand the necessary experience in approving insufficiently collateralized credits, and thus justify the basic goal for introducing the guarantee scheme.

A.3. GENERAL PROCEDURE AND NECESSARY RESOURCES

Common to both guarantee funds is that it is recommended to link them to the MEDF credit line, and it is suggested to have a strong automatism in their approval, with only a limited examination whether the extremely limited conditions in both cases are met.

The recommended linking of the two guarantee funds to the MEDF credit line simplifies to a large extent the administration and reduces the expenses for approving guarantees and monitoring of their progress. A slightly larger effort is required in the design phase of the guarantee funds, because it is necessary to be very careful during this phase: the success of the guarantee funds depends more on the design than on the implementation. During the implementation phase, the only thing that needs to be done is to upgrade the revenue documentation system by registering the reimbursements for the guarantees and expanding the monitoring on how the credit program is progressing, with a special analysis of the flows of the guarantee funds and the risks.

MEDF's effort, time and expenses increase only during the activation phase of the guarantees against war risk, when MEDF should contemplate decisions and undertake measures for dealing with the decision. In the case of the guarantee for insufficient collateral, activation does not cause special measures and operational expenses because MEDF remains a passive actor that only covers the final loss of the bank.

B) GUARANTEE FUND AGAINST WAR RISK

B.1. NEEDS FOR ESTABLISHING A GUARANTEE FUND

a) Background

Even without a quantitative illustration and discussion about the reasons, the fact is well known that the north-western regions were always less covered with bank credits. During the last few years, if not the relative than at least the absolute amount in credits in these regions began to increase. However, after the military actions in 2001 in the north-western part of Macedonia, the banks ceased to approve credits in that region. This is a normal, even necessary bank reaction towards higher risks, brought on by military actions in regard to disturbing economic flows and causing difficulties in the execution of collateral.

After the military actions ceased, it was concluded - at least at several banks where this issue was discussed - that there had been no major deterioration in the portfolio in these areas, i.e. that the debtors in general continued to pay their obligations regularly, even though somewhere with some reprogramming. Nevertheless, the banks as a whole are slow in renewing their supply of credit in these areas. In general, the share of credits in these areas in the overall portfolio of the banks remains minimal, and even continues to decrease with the faster growth in the overall supply of credit, compared to the supply of credit in these areas. This imbalance has a negative effect upon the economic situation in these areas and upon their integration into the general economic environment of the country.

b) Market Aspects

The halt in crediting was primarily caused by the war in 2001 and the fear among banks of a repetition of the war, or if a crisis situation should appear that would create difficulties in the collection of the credits, both because of the business risk, as well as because of the impossibility to execute collateral. We shall foresee these risks under the common title of "war risk". War risk is not a standard banking risk. Since they cannot manage this risk, the banks are extremely cautious with it, either by completely avoiding supply of credit in these areas, or by making a selection of credits depending upon the micro-location within the region, or by globally limiting the amount of exposure in these regions. Besides, this risk does not fall under the group of actuarial risks, either, i.e. the risks that can be expressed statistically (these are massive and comprehensive, in the sense that they target all the businesses in a specific region). All this makes it impossible to cover this risk with some commercial insurance mechanism, similar to the way insurance avoids all real estate in these parts of Macedonia or the real estates of Muslim communities in Bitola during the war, and similar to the standard avoidance by insurance companies to insure against consequences from earthquakes (because of the non-selective way a whole region is affected).

B.2. OTHER SIMILAR INTERVENTIONS IN THE SECTOR

In comparison to the numerous and varied schemes for covering other types of risks (such as for example the risk from sufficient collateral), it is much more difficult to find relevant examples for covering the above described and similar risks.

An interesting illustrative example is MIGA (Multilateral Investment Guarantee Agency), member of the World Bank Group, which offers coverage for several similar non-commercial risks, such as restriction in transfers because of no access to foreign currency, expropriation and breach of contract, but also risk of war and civil unrest (including revolution, revolts, state coups, sabotage and terrorism). MIGA is limited to covering the risk of investors in regard to their investments or their or third party long-term credits or guarantees that are linked with their investments. The bottom limit of the guarantee is not determined, but the nature of these guarantees can easily be seen also from the fact that the upper limit has been set at USD 200 million. The standard rules of MIGA are applied also in the case of Bosnia and Herzegovina, where MIGA appears not only

independently, but also as an administrator of a special trust fund of the European Union for such guarantees, and where several larger investments are covered in a total value of around USD 30 million. There is still no example where MIGA has been used for any kind of guarantee in Macedonia.

B.3. PROCEDURE - MECHANISMS FOR PROVIDING GUARANTEES

a) Defining the risk clause

In the maximal version, defining the clause for covering risk should necessarily cover all risks, so that the banks can consider that they are sufficiently covered against such risks, to isolate these from their credit decisions and to focus only on the usual banking risks. However, these risks are not so easy to define.

The risk of occurrence of military actions may be defined in several ways. The most frequent definition is "proclaiming a state of war" or some other formal act that can easily be determined ("it is published in the Official Gazette"). However, experience shows that it may happen that formal acts are not used, and thus this would not satisfy the banks. In case a formal proclamation is missing, it will be difficult to find a satisfactory practical "quantitative" definition of military actions, especially in the sense of making a distinction in regard to simple incidents. One can try with a combination of the fact of military actions and the fact of consequences that can be easily determined. An example of this is "when as a result of military actions the court authorities refuse or avoid to execute rulings that have come into effect".

The risk of prolonged uncertainty of military actions and the non-functioning of the legal system is even more difficult to define. It seems most practical to rely on the execution of the collateral as a fact that can be determined relatively easily. It will be sufficient to set up a deadline by which a court verdict on the collateral is not executed, which would breach the legal deadlines (eventually prolonged for a small period of time, which is the usual breach of these deadlines by the authorities).

The above distinction in the expression of specific risk events points also to the possible general orientation of the clause on the risk event. It seems that the best solution is for it to be double: occurrence of military actions and difficulties in executing collateral. The risk of economic deterioration arising from the uncertainty of military actions should not be covered, simply because it is not possible to set up a precise definition that would satisfy both sides.

There is another possible view upon the above described risks. Because it is not expected that the available fund would be very large, one can go with an initial definition of the risks only in the segment of direct military actions; conceptually, this would be the cleanest solution. If the fund is spent even with only this definition, then the goal would have been achieved. If the fund is not spent at all, i.e. if the guarantee fund defined in this manner does not satisfy the banks sufficiently in regard to approving credits in these regions, then the definition would be expanded towards risks that are not strictly connected with the occurrence of military actions. For example, one could start with a cumulative definition (collateral cannot be executed because of military actions), and only if the scheme does not function, one could apply softer options ("the collateral is not executed within legal deadlines", "military actions have occurred", etc.).

b) Is the guarantee valid only for MEDF credits?

In theory, this scheme could be offered for all possible credits. However, linking the guarantee with only MEDF credits provides an automatic compatibility with the goals of MEDF and it is much easier, both for design as well as for administration. Because of this, it is recommended that during the initial period the guarantee should be limited only to MEDF credits, and only after some time, if there is still need and demand for such a guarantee, to contemplate an eventual expansion of the guarantee to other credits. This would basically be equivalent to commercialisation of the whole

scheme. The guarantee fund would cease to be only a secondary tool of the MEDF credits and would grow into a special and independent product.

A separate issue is whether the guarantee against war risk should be allowed to be available for already approved credits, i.e. whether the banks should have the possibility to "buy" such insurance for already approved credits. Offering the possibility to insure already approved credits would be extremely interesting from the aspect of monitoring the attractiveness of the guarantee. This would make it possible to get a clear quantitative instrument for discovering how the banks perceive this risk. However, this possibility would be incompatible with the basic goal of the guarantee. Namely, the basic goal of this guarantee is not protection of banks against war risk, but rather enabling the provision of credit to risky regions by means of protecting the banks against war risk. Covering the risk for existing credits would be in contrary to the principle of "additionality", i.e. with the goal to enable approval of credits that otherwise, in the absence of the guarantee, would not be approved.

c) Price of the guarantee

From the commercial point of view, the price of a guarantee should cover the "cost" of the guarantee, and this means the operational costs linked with the guarantee, plus the probability of losses from the guarantee, plus the necessary profit. In the case of a guarantee against war risk, we have the following situation:

- a) Operational expenses are extremely low (this is explained separately later on);
- b) The probability of loss cannot be foreseen because the occurrence of military actions is not an actuarial event. However, the idea itself is based on the fact that there will be no military actions and that the banks only need to be encouraged for this view (otherwise, MEDF would not approve such a guarantee). Therefore, for operational purposes, no other price can be built into this component but zero.
- c) The profit is not a criterion because MEDF is a non-profit organisation and this guarantee is not provided for earning profit.

This means that the "expense" of the guarantee is small.

In the case of a limited quantity product, such as this guarantee, another criterion for determining the price is maximising revenue, i.e. the best price for the guarantee is the maximal price for which the available fund would be spent. The price is a self-regulating mechanism - per definition, the price is not excessive as long there is enough interest for this product at that price. The price is a perfect allocation instrument - the product goes to those who need it most and therefore are prepared to pay the most. Because of this, there is logic in determining a price that would be relatively high for such a limited product.

A separate dilemma is who should bear the price of the guarantee (regardless whether this is determined based on "expenses" or on "revenue"): the debtor, the bank or MEDF.

The debtor is the most natural payer of the price, especially if the "additionality" principle is applied, i.e. considering the alternative that the credit would not be awarded if there was no guarantee. Thus, the guarantee is simply the price for receiving the credit. In that case, an objective situation will be created where debtors from the crisis regions are discriminated, and who for the same credit have to pay a higher interest than those in "non-risk" regions. However, this discrimination is a realistic reflection of the real situation, where these credits bear larger risk. The level of risk in itself bears negative consequences, and the higher interest is only the price for avoiding the alternative consequence - for the credit not to be awarded at all. Even though the payment of the guarantee price would not be unfair, in order to mitigate this effect one could contemplate the option to return a part of the paid price if the risk event does not occur and if the credit is properly liquidated.

The bank is not a natural payer of the guarantee price. The guarantee price would eat into the margin which the bank has determined as adequate for a MEDF credit. If the bank would "buy" the

guarantee, then effectively its margin would be smaller, and this would immediately be compensated with an increase in the final interest rate, which again would mean that it is passed on to the debtor.

MEDF can be considered as a party that could be prepared to pay the price of the guarantee because it also "gains" if the bank approves a credit in the "riskier areas", in the sense of achieving its programme goals. The way it is set up, MEDF is not in the position to carry out profit discrimination (i.e. to do what brings in the most revenue), and it is even directed towards negative profit discrimination (it does things that clearly bring in less revenue, in order to implement its programme goals - such as for example, placing high-revenue deposits in low-revenue credits). The eventual avoiding of this profit dimension by MEDF would be expressed by avoiding the "revenue" component of the guarantee price and alimentation of only the expenses. In theory, with the same logics, MEDF can bear the expenses. However, one must also be aware of the generally desired rule of avoiding benefits that are free of charge, or almost free of charge. Thus, determining a certain price is a necessity.

All in all, it seems that the winning combination is to set a price for the guarantee at a relatively low level, which undoubtedly would cover the expenses, and which would be sufficient so that it is not perceived as free of charge. The guarantee price of 1% of the amount of the unpaid principal seems to be the minimal threshold for being serious, and 2% seems to be the maximum limit for this seriousness, before it becomes profit oriented.

A suggested calculation is that it is built onto the interest rate in both directions: MEDF-bank and bank-debtor. In this way, one gains in simplicity, reality (the price of the guarantee is paid upon the outstanding amount of the guarantee) and economy (no complicated systems are required to monitor and collect the guarantee, either by the bank or by MEDF).

The principle of paying the guarantee price by building it onto the interest rate can be combined with paying the guarantee price through a one-time fee, payable in advance. This is especially desirable if the option is applied to return the paid interest in the case when the risk event did not occur and the credit was properly liquidated. Namely, in this case, the one-time fee would represent reimbursement for the expenses for the guarantee, while the additionally paid interest would cover eventual additional expenses that would be incurred with the occurrence of the risk event.

d) Percentage rate coverage of the guarantee

With all guarantees for bank risks it is almost unavoidable to have a percentage rate coverage of the risk with the guarantee, i.e. sharing the risk between the guarantor and the bank. This is also done in order to avoid the so called "moral risk", in the sense of liberal provision of credit by the bank regardless of the risks that are otherwise covered 100 percent. However, this assumption is irrelevant for the war risk. The bank continues to bear the full business risks from credits approved in the "risk regions", thus fully preserving responsible decision making by the bank. At the same time, the bank is not required to "responsibly" assess the risk of military actions because this is not in its line of duty; and MEDF exactly wants to free the bank from contemplating such a risk. Therefore, there is no reason here why that coverage should be less than 100%.

Nevertheless, there are two "small" reasons why one could contemplate an eventual sharing of risk. The first is that it may not be a bad idea for the bank to have some kind of role in assessing the risk of military actions. The second is that by supplying a credit to a client in the risk areas, the bank gains other business elements besides the interest (for example, "penetrating" a region where other banks are absent exactly because they are not covered by the guarantee fund). Because of this, it is possible to contemplate a symbolic participation by the bank in the risk with for example 5-10%.

B.4. TARGET GROUPS AND AREAS

a) Target area for the guarantee

In regard to the territory that would be covered by the guarantee fund, the surprising conclusion is that such a definition is not necessary, because the banks themselves may conclude for which credit they would go with an increased interest rate. No bank would be motivated to increase the interest rate for some credit, for example in Strumica. At the same time, a bank may assess that such "insurance" may be necessary, for example for some credit in Kicevo, even though this territory would not be so acceptable for MEDF. In any case, the bank's assessment is relevant. This kind of flexibility is made possible by the instrument of building the guarantee price upon the interest, both towards the bank, as well as towards the debtor. Thus, the bank has no motive to request unnecessarily a "guarantee" because it gets nothing out of this. On the other hand, increasing the burden upon the debtor is not favourable for the bank, either, both from a marketing aspect (the awarded credit is more expensive), as well as from the aspect of a smallest possible burden upon the creditor, creating a better potential for servicing the debt. Because of this, it may be considered that sufficient incentives exist for a responsible utilisation of the instrument by the banks. It should be stressed that, *ceteris paribus*, the higher the guarantee price is the less favourable is its application, and therefore the responsibility in its implementation is higher.

A separate issue is the application of the term "territory" when the guarantee is activated. If the military actions occur in the Tetovo area, shall guarantees from Struga be considered as activated? If a whole village region around Gostivar becomes inaccessible to the court authorities, shall the guarantees for credits in the city of Gostivar be activated? Intertwined are also the criteria about the seat, activity and location of the collateral.

The best legal solution is for the whole guarantee to be linked with the collateral and its execution. The location of the collateral can easily be determined; accessibility and possibility to execute the collateral are also facts that can be determined. Thus, the guarantee fund would only guarantee that the collateral would not be damaged during military actions, and that it can be executed - in the sense of being available for selling. In the extreme option, if the banks still refuse to rely upon such a guarantee by MEDF, it is possible to guarantee the purchase of the collateral by MEDF up to the level of the guarantee (thus, MEDF undertakes the risk of selling), but only in cumulative combination with the condition of military actions.

If the guarantee is not linked only to the collateral (but if general economic damages from military actions are also guaranteed), large uncertainties appear regarding the activation of the guarantee. These uncertainties may be overcome to some extent by a precise definition of the guarantee (for example, the debtor himself should demonstrate, at the time when the guarantee is concluded, in which regions he has major activities, as well as by using the traditional municipal principles of linking: Tetovo area, Struga area, etc.). On the other hand, there is a reasonable limit in the extensive definition of the coverage (for example, the bank will certainly not expect that the guarantee will be activated because the Bitola collateral to a Tetovo credit cannot be activated at a good price because of general economic uncertainty because of events in the Tetovo area, since this is a risk that concerns also "normal" Bitola credits). Nevertheless, in the situation of a limited fund it seems more practical that the guarantee fund should initially be placed only at the level of the collateral, and eventual expansion should be reviewed only after a possible initial failure.

An interesting idea is to set up a "price argument" in the concrete decision of the bank. Namely, it is best when the bank is placed in the situation to choose between maintaining the status quo situation by retaining the current interest, and accessing execution of the collateral but sustaining a certain monetary damage. In this case, the contractual definition of the activation of the guarantee will be looser, because the bank will have an economic argument to retain as long as possible at least the good credits. This is already a serious reason to introduce at least a symbolic participation by the bank with 5-10% in the covering of the damages.

b) Target group of the guarantee

There are no evident commercial reasons for discrimination in regard to the target group, if the decision is made for debtor to pay for the guarantee and the location of the collateral to be the criterion for the guarantee (while the bank would determine the covered territory). All those who cannot obtain a credit because their collateral is in a risky region deserve that this hindrance should be removed by a simple upgrading of the interest. This would concern small farmers, small enterprises and large enterprises.

The guarantee fund may also have a non-commercial reason for additional limitation of the target group. This could be the condition that the effects from the credit should be reflected exactly in the risky regions, as a kind of contribution towards enlivening economic life in those regions (and not to cover, for example, Bitola credits with Tetovo collateral). The formulation of these "effects" is already applied in regard to the "rural effects" with current MEDF loans. However, in this case one should define the territory for which these effects would be linked to. One option is to cover the regions where military actions took place in 2001. This kind of definition is precise, but it is not completely adequate for the goals of the guarantee fund, because the banks often see a risk also in areas that were not directly affected by the war (e.g. Gostivar). The second option is to list all the municipalities that have an Albanian population in excess of a specific percentage (e.g. 30%). Regardless how rough this sounds, looking realistically the percentage of the Albanian population is the risk factor. A third option is to give a "macro" definition of the territory, i.e. all municipalities from Tetovo to Struga, plus the municipality of Lipkovo and eventually some Skopje municipality. A fourth option would be some descriptive definition, such as "western and north-western parts".

B.5. SUMMARY OF THE PROPOSED ELEMENTS OF THE GUARANTEE

Risk event: Breaching the legal deadlines for execution of the collateral because of a failure by the state authorities to completely conclude the procedure for transferring ownership and governance over the collateral, caused by military actions.

Target area: the location of the collateral is not limited and it is according to the full discretionary decision by the bank, but the effects from the activity should be within the determined zone, in conformity with the listed principles or other criterion.

Target group: all credit beneficiaries who perform an activity in the target area.

Guarantee price: a one-time fee of around 1%, plus at least 1% built onto the annual interest rate between MEDF-bank and bank-debtor, with an eventual option to return the additional interest in the case of a proper liquidation of the credit.

Percent of guarantee coverage: 90-95%

Approval procedure: the bank and MEDF conclude a separate (framework) agreement for the guarantee, and a specific agreement is freely determined by the bank, after it checks out the target area for the effects from the credit and it reports its desire to MEDF. MEDF eventually controls only the logic of those effects, the fact that the guarantee is registered in the loan agreement (where the interest rate is also increased for the guarantee price).

Procedure for activation of the guarantee: the two most important moments - the moment of activation and coverage of the funds - are explained in detail in the following text.

a) Moment of activation of the guarantee

The bank is a far better manager with standard credit risk and better manager of bad credits than MEDF. The longer the bank carries the credit risk, the better is the credit. MEDF has no need to be involved in the management of the credits where its guarantee has been approved. However, at the moment when the bank would not feel the credit risk, its credit management would deteriorate

significantly. In that case, some involvement by MEDF is necessary, as an already real owner of the credit risk, even though the technical management continues to be entrusted to the bank.

Even though not all combinations from the real world can be foreseen, the following scheme seems appropriate:

- the bank manages the credit normally, with a MEDF guarantee, up to the start of the military activities, without any involvement by MEDF;
- if military activities occur, which are defined by the agreement, then the bank concludes that the first condition for activation has been met, and it informs MEDF about this; MEDF agrees in writing with the occurrence of the fact;
- if the debtor continues with regular repayment or with occasional delays that are not alarming for the bank, no steps are undertaken, either by the bank or by MEDF;
- the bank monitors the repayment and may restructure the credit if this becomes necessary, thus at the same time restructuring the obligation towards MEDF, as well (only for those credits where it has already been concluded that the first risk event has occurred - military actions).
- If the debtor ceases to make repayments, the bank informs MEDF about this; the bank may decide to go into activation of the collateral; MEDF may prevent this, hoping that the situation could be normalised, but only with explicit agreement that the guarantee has legally been activated and that the bank could at any time request reimbursement for the guarantee;
- If the second risk event occurs (the competent authorities are unable to perform some important step in the execution of a mortgage or if they breach the legal deadlines for that step), the bank concludes that the second criterion for activation of the guarantee has been met, and informs MEDF about this;
- because of the credibility of the guarantee fund, after MEDF verifies that the risk event has indeed occurred, it should confirm this formally and release the bank immediately of the credit risk, whereby several sub-options are possible. MEDF may:
 - take over the rights and management of the collateral;
 - agree with the bank that it continues to manage the collateral;
 - conclude a separate agreement with the bank, so that it could continue normal management of the credit, without activation of the collateral.

It seems most natural that the management of both the credit and the collateral should remain with the bank; however, in combination with establishing a special communication with MEDF and the right of MEDF to issue instructions. Undoubtedly, MEDF would bear all the direct costs in this regard. MEDF could also bear a part of the indirect costs (including also partial engagement of the bank personnel), by means of establishing a special so-called management fee; alternatively, it is possible for the bank to agree in advance to cover such costs, as a kind of in-kind contribution by the bank to the whole guarantee fund.

b) Covering the funds for an eventual payment of the guarantee

All successful guarantee funds are based on secure payment upon a request to activate the guarantee. The security implies two aspects: precise definition of the risk event and confidence in the availability of funds. The first aspect is covered here above and it should simply be negotiated with the banks. In regard to the second aspect, there are two possible modalities:

- placing a special purpose deposit by MEDF - this could be a long-term restricted deposit, which bears interest at least in the amount determined by the acts of the bank for such a deposit, and which could be "sequestered" by the bank under a specific procedure if a risk event occurs;
- utilisation of the fund for repayments by the bank to MEDF for this purpose - which means that if a risk event occurs, the bank will simply have the right not to pay the obligations towards MEDF.

The second option is very easy for administering, because it does not require special negotiations between MEDF and the bank for imposing an interest rate upon this deposit. This makes it possible for MEDF to start testing this product without engaging special own or somebody else's assets. However, this is where the dimension of managing risk appears. Regardless to what extent the war risk is assessed as unreal, prudence requires that it is reviewed as one of the potential risks. This means that MEDF should set up its own internal limit as to how much it is willing to be exposed to this risk. The best solution is to express this limit as a ratio of the overall current loan fund (e.g. 10%). MEDF can exceed this limit only if it receives "reinsurance", for example through additional funds that are intended exactly for that purpose.

On the other hand, the first option means isolating the war risk from the overall loan fund, thus maximising the protection of this fund. By providing a special deposit, there is additional interest revenue from that deposit, which serves also as additional protection against losses if the risk event occurs and losses start to accrue. In comparison to the first option, an additional administrative benefit appears, in the sense that there is a fixed initial depreciation plan between MEDF and the bank, and there is no need to adapt it every time some collateral is threatened.

Besides this concrete modality, another dilemma that needs to be resolved is whether with the occurrence of the risk event the bank shall consider its claim as fully matured, or whether the maturity of MEDF's obligation towards the bank should be in conformity with the dynamics of the unpaid obligations of the client towards the bank. For numerous reasons, from principle to practical, the solution seems superior where MEDF acquires and pays out the obligations gradually, in the same way as the obligations of the final debtor reach maturity. The most important fact is that the possibility remains to service the credit normally if the situation normalises (even though this opens up the possibility for the bank to decide easily to activate the risk event every time when a similar situation appears, knowing that if the situation normalises there will be no consequences, but even that could be covered adequately). In any case, MEDF would reserve the right to request momentary maturity of all claims (if it assesses that this is in its best interest).

B.6. RISKS AND SUSTAINABILITY

a) Insufficient interest among the banks

This is the main risk why the guarantee fund could not come to life.

The banks may decide not to show adequate interest for applying the guarantee fund for two reasons: a) because the provision of credit in those regions is so far outside of their business policy that no guarantee funds can compensate for this; and b) because the covering of risks that may be offered by MEDF is not sufficient for their perception of those risks.

The first reason is insurmountable because here the war risk is irrelevant. The second reason is solvable, with a higher level of flexibility by MEDF in formulating the risk events (within the general framework of a reasonable definition of these events).

b) Disagreement by the debtors to pay higher costs for the guarantee

In a situation of insufficient supply of credits, especially in the risky regions, this risk is relatively small, up to the point where the guarantee price is set at a prohibitive level.

c) Using the guarantee fund for already approved credits

A traditional risk with the guarantee funds is that the bank will not use the guarantee fund for new risks from newly approved credits, but for covering the existing risks in existing (bad) credits.

By its nature, this risk does not appear in the guarantee fund in an acute form, because the bank cannot be sure that there will be an occurrence of the risk event. Such a risk may appear if the situation deteriorates to such an extent that the bank would try to reprogram its existing credits

towards the debtors from the risk regions with new MEDF credits. However, because in the case of an acute situation MEDF itself would refuse to guarantee such credits, this risk is very small.

Another issue is that the bank may desire to transfer a good part of its credits in those regions under such a guarantee. This intention cannot be prevented effectively, but there are also arguments that draw in the other direction, such as the not insignificant expenses of such a conversion and a serious breach of the basic framework agreement between MEDF and the bank, and the partner relationship that arises from that agreement. Even if these arguments do not prevail, and the banks start such a transfer of credits, MEDF will anyway have the benefit of knowledge about the large "popularity" and need for such a guarantee fund.

An interesting distinction appears in regard to the issue of prolonging matured obligations from existing credits, or complete reprogramming of credits. When the debtor is prepared to repay the credit, but he is asking the bank to extend the term, this may be considered as an approval of a new credit, and as such the guarantee would be available. When the debtor is not able to repay the credit, and the bank extends or reprograms it, then we are talking about a "follow-on" of the guarantee on an existing credit that is being extended because of need, and not as a choice of the bank. Of course, it is much more difficult to make this distinction in practice, compared to the above theoretical explanation.

d) Sub-optimal utilisation of the guarantee fund

The guarantee mechanism may be used by the banks in a manner that will be in full conformity with the signed agreements, but which would not respond to the goals for its introduction by MEDF.

For example, it may be that the guarantee fund covers the requests for credits with mortgage, which are located in the crisis regions and for companies that have their seat in those regions, but the operation of these companies and the effects from these credits would be completely outside of those crisis regions. A second example is when the guarantee fund is used in the crisis regions, but channelled towards members of the Macedonian community, thus only increasing further the ethnic imbalance in the utilisation of the credits, instead of helping to soften this imbalance.

This risk cannot be covered by over-regulating the agreements in order to provide achievement of the goals. The goals and efforts of MEDF in regard to the guarantee fund should be presented to the banks (this can be done by an appropriate general clause or "preamble" to the agreements), and after this, one can simply rely upon their partner relationship and understanding.

e) Overly extensive interpretation of the occurrence of the risk event

The banks may consider the smallest incident or problem in execution of the collateral as an occurrence of the risk event and request immediate coverage of all their credits with guarantees.

This risk is unavoidable even with the most precise formulation in the guarantee agreement, especially since this agreement cannot foresee all the possible situations that may occur in the future in the risky regions. Nevertheless, a maximum effort should be made to increase the precision of the formulation in the agreement, at least for those vague areas that can reasonably be foreseen at the time when the agreement is concluded.

f) Occurrence of a risk event and sustaining of losses by MEDF

This is the key risk for the already operational guarantee fund. The occurrence of a risk event is of course completely outside of MEDF's influence. The intensity of damages upon the collateral and the procedure for execution are also not controllable.

Most important is first to limit this risk, as was already recommended, by limiting the amount of approved guarantees and the possibility to exceed this limit only with a credible reinsurance.

Then, this risk should be controlled, meaning that the situation should be monitored and approval of new guarantees should be stopped when the occurrence of the risk event becomes certain, regardless of the eventual unfavourable implications from such a decision.

After this the risk should be managed, by making the right decision when the bank reports the occurrence of the risk event, in regard to accepting this notification, deciding on the best procedure from MEDF's point of view, and carrying out efficient negotiations with the banks about how to proceed further. This includes making well grounded assessments about the procedures (for example, whether any kind of execution of collateral should be started immediately, or whether one should wait a while, regardless of the risks of damages to its value).

C. EXIT STRATEGY

The guarantee scheme against war risk is not a revolving fund with open maturity. This would have a long life only if the military tensions remain for a longer period of time (with or without occasional activation), and if MEDF and other sponsors continue to cover this risk. The guarantee scheme would have a short life if the risk event occurs, and the losses are such that they would completely deplete the available fund. Nevertheless, the expected flow of events is that the guarantee scheme would have a limited life span, in the sense that the risk event will not occur, after some period of time there will be no perception of the above described risks, and the banks will no longer see the need to burden their clients with the payment of a special supplement for a risk that is objectively too small. In that case, the guarantee scheme would become some kind of "technological surplus" and the engaged funds, or the risk that was taken over, would be released.

D. GUARANTEE FUND FOR A LACK OF COLLATERAL

D.1. THE NEEDS FOR ESTABLISHING A GUARANTEE MECHANISM

a) General context

Up to World War II, the credit guarantee schemes did not take on or play an important role in the so-called liberal economies. Anticipating the needs for post-war renewal and economic development, companies become more specific in their demands and efforts to finance their modernisation. However, it was a common phenomenon for all countries that small and medium enterprises (SMEs) lacked collateral. Confronted with such a situation, guarantee mechanisms began to spring up and were developed significantly.

One of the main needs for establishing a GF was the difficulty of SMEs to secure adequate collateral, according to the demands of the banks, as a security for the approved credits. By means of issuing guarantees, GF enables SMEs easier access to receiving credits. The credit guarantees help the SMEs to acquire funds for supporting their development or their current operations.

The guarantee mechanism is used by those SMEs that operate normally and have the need for external financing, but do not have adequate collateral. Through the GF and the credit guarantees, SMEs will solve their problem with the banks in regard to acquiring credit funds regardless of their lack of collateral.

b) The context in Macedonia

This universal problem of inaccessibility of credits appeared also in Macedonia for those entrepreneurs who do not have sufficient collateral to meet the demands of the banks and receive credits from them. Furthermore, it can be considered that this problem was more expressed because of the parallel effects of two factors: an imbalance between credit supply and demand, and the history of big credit losses of the banks. Namely, the credit losses of the banks pushed them towards a higher level of caution and more severe demands on collateral, while the imbalance between credit supply and demand made it possible for the relatively scarce available credit funds to be placed as credits with excellent collateral, sometimes even at the level of three times the value of the credit. This caused the closing down of access to the credit market for entrepreneurs with insufficient collateral.

More recently, there is a rise in non-obligated credit funds because of the capitalisation of the banks, an increase in deposits, availability of credit lines, and numerous regulatory reforms that eliminate the existing credit limitations. With the development by some banks of a history of small credit losses, there is a strengthening of their credit "boldness" and the second factor is mitigated. However, this is just a relative improvement in the accessibility of credits. Additional changes are necessary for Macedonia to come closer to the credit accessibility of the more developed countries, while it is still a level where there is a need to expand this accessibility by means of various guarantee schemes.

D.2. OTHER SIMILAR INTERVENTIONS IN THE SECTOR

a) A short description of the existing schemes

There were various efforts to resolve the problem of accessibility to credits for entrepreneurs with insufficient collateral in Macedonia, from sharing the risk with the National Enterprise Promotion Agency (NEPA), as a first such scheme, and up to the Guarantee Fund and the announced state guarantee fund, as more recent initiatives. These various solutions are described in more detail within the separate Annex, and here we shall stress only some of the more important items.

NEPA's scheme for risk sharing was valid for credits approved for financing and participation by NEPA (mid-term credits of up to 1.8 million denars in specific sectors, for companies of up to 20 employees). NEPA undertook upon itself to compensate the banks for up to 70% of the losses from non-repaid principal, for the part of the loans received from its own funds (maximum 2/3 of the credit). With this, the effective coverage of the bank against losses was under 50%. The banks had the right to demand reimbursement of losses only after all reasonable means had been used through normal banking procedures in an effort to collect the matured credit instalments, and to submit a claim to the competent court for collection of the claim. To date, not a single demand has been submitted for reimbursement of defaulted claims, even though there are indications that specific claims are coming to the point where all mechanisms have been exhausted and a loss has been expressed that would be "complained" to NEPA. With the suspension of the credit line through NEPA (which since March 2003 is serviced through the Macedonian Bank for Development Promotion - MBDP), this scheme can actually no longer be considered as an existing solution to the problem of insufficient collateral.

As a continuation of the German credit line implemented through Almako Bank, there is a guarantee mechanism in Macedonia within the framework of the same credit line, supported by DEG, which is now serviced by MBDP (long-term credits of up to 150,000 euros, primarily for new businesses). The guarantee is issued for credits that are secured by a collateral of at least 35%. The participating bank may request payment of the guarantee only after previously having activated all the available security instruments and having exhausted all the legal remedies for collection of the claims. Funds of the Guarantee Fund are used to compensate a maximum of 65% of the finally outstanding claims from the borrowers. This scheme has no registered claim for covering losses, either, and it is not very operational at present. Even though it seems as if this scheme is better formulated, it cannot be considered to be a currently functional solution to the problem of insufficient collateral, just like the previous example.

The first guarantee mechanism that is not linked to a concrete credit line is the Guarantee Fund, established by the Centre for Development Promotion for SMEs (CDPSME), with a donation from CIDA of 500,000 euros. The Guarantee Fund covers farmers, new SMEs, and existing SMEs with up to 50 employees. The guarantee is issued up to 20,000 euros, or up to 60% of the credit, based on a special proposal by the applicant, which is formally approved by the Guarantee Fund. During the period of February 2002 to May 2003, interest was shown by a total of 86 persons, of which only 17 applied and one was rejected; thus, a total of 200,000 euros have been approved. It is expected that with the announced increase in the fund (additional 1 million euros in October, 2003), operation will become more aggressive and the number of guarantees shall be increased, as well as the coverage by the banks (at present, 70% is implemented through Tutunska Bank, and the remainder through Invest Bank and Komercijalna Bank). With its current operations and with the announced increase in funds, the Guarantee Fund may be considered to be an existing solution to the problem of insufficient collateral, even though somewhat limited by the available funds and the existing cooperation with only three commercial banks.

It should be stressed that in the past, a full attempt was made in Macedonia to establish a guarantee fund specifically targeting the western parts of Macedonia, through a specific commercial bank. This attempt was designed as a kind of upgrading of the Enterprise Support Centres (ESA) in Ohrid, Gostivar and Tetovo, financed by the British Know-How Fund, and intended for delivering services to potential clients in the form of consultations, preparing business plans and various trainings in the area of economics. This scheme was based on the experience of the leading foreign consultant of the ESA centres (Peter Milford) with the credit guarantee schemes applied at a regional level in Wales and Poland. The whole project was stopped when the military actions occurred in 2001; it was also evident that the banks showed a low level of interest.

A draft law on the guarantee fund was prepared, with which such a fund could be established as a state fund, managed by a professional company, with the aspiration that it would be the largest provider of this kind of guarantees. This fund could represent a real source for meeting the needs from insufficient collateral, even though the whole process from proposing and enacting the law and up to the fund becoming operational may be rather long.

b) Comments on the existing schemes

NEPA's guarantee scheme does not represent a traditional credit guarantee fund, but it was a kind of derivative, represented in the form of "sharing the lending risk". In this concrete case, instead of confirming the risk by issuing a credit guarantee, a form of reimbursement of obligations and claims was applied.

Without doubt, in regard to an efficient reimbursement of the credit loss, the reimbursement would be satisfactory, but it has a very important weakness, namely by covering credit losses, the credit fund is *de facto* eroded and undermined, being the only cash funds from which the loss is compensated. On account of the "secure" mechanism for compensating credit losses, there is a loss in efficiency, purposefulness and basic function of the credit fund; the guarantee fund is supposed to serve this function, instead of weakening the position, goal and purpose of the funds of the credit fund.

Because of the above mentioned reasons, it is not surprising that in the case of DEG's guarantee scheme, as a second such attempt in Macedonia, an effort was made for a guarantee fund that mainly respects the principles of similar funds. Here, instead of reimbursement, a true guarantee is issued, as a possibility to cover an eventual credit loss.

As mentioned above, it is interesting that there are still no demands for reimbursement of credit loss by the banks, either to NEPA or to DEG, being guarantee schemes with a longer history, nor to the Guarantee Fund, as a guarantee scheme from a more recent period. The reasons may be multiple and varied:

- 1) Insufficient knowledge about the mechanism for using the scheme;
- 2) Continued insistence on first-class collateral by the banks;
- 3) Quasi-savings to the reimbursement fund by the banks;
- 4) Successful procedures in forced collection;
- 5) Prolongation of the procedures for forced collection;
- 6) Impossibility to provide the necessary documentation for reimbursement.

Be it as it may, in general, the issue is raised of the purposefulness of the existence of the guarantee fund, in cases where it is not used, even if the reasons were that the banks do not want to "damage" the guarantee fund, or that they have secured such good security that they do not need the guarantee fund.

While the guarantee schemes of NEPA and DEG are somehow fading away, there is an existing expansion of the Guarantee Fund, which differs from the two other schemes, also by the fact that it is a "general" guarantee scheme that is not linked to any existing credit line, and therefore there is a special parallel procedure for approval. This is followed up by the announced state guarantee fund.

When the Guarantee Fund would be longer-term and dependably efficient and sustainable, and if the state fund would be fully operational and just as efficient and sustainable, then it could be considered that the area of guarantees for insufficient collateral is sufficiently covered in Macedonia as a concept. If the aggregate capacity of both institutions would be larger, it would also be considered that this concept has been effectuated in sufficient supply. At present, the only operational capacity consists of the 500,000 euros of the Guarantee Fund. Even with the announced increase by 1,500,000 euros, this is still only an insignificant percentage of the overall credit portfolio of the banks. This is definitely insufficient for all the needs that would appear with regular refinancing of the relevant part of this portfolio, year-in year-out. Therefore, regardless of previous and existing initiatives, the area of the guarantee fund cannot be considered as exhausted, both in regard to the concept, as well as to the amount. This opens the road for an eventual separate guarantee scheme within the framework of MEDF.

D.3. TARGET GROUPS AND AREAS

A guarantee scheme could be linked to a specific credit line (such as NEPA or DEG), or general (such as the Guarantee Fund or the announced state fund). In a situation where MEDF manages a special credit line, and even if the aspirations regarding this guarantee fund are larger, it is advisable that the guarantee scheme is prepared initially for its own credit line, so that all mechanisms can be tested with a smaller and much more familiar sample.

It can be said that the goal in establishing the GF by MEDF would be to expand the support and assistance to SMEs in the area of facilitated access to partner banks, as well as increasing their competitiveness in obtaining credit funds.

Credit guarantees will be issued to clients of MEDF partner banks, which use the credit products in conformity with the framework agreements concluded between MEDF and the partner banks. The credit guarantees will cover the risk of insufficient collateral.

There are four types of SMEs, depending on the target group for establishing a guarantee mechanism:

- enterprises meet the conditions for collateral, but not the other criteria;
- enterprises meet both the conditions for collateral as well as the other criteria;
- enterprises meet the other criteria, but do not have sufficient collateral;
- enterprises do not meet the conditions either for the collateral or the other criteria.

The function of GF is to support the SMEs defined in the third group.

The target group of the GF may be determined depending upon the type of business activity and the size of the companies. According to the present types of clients, they could be characterised according to the credit programme supported by MEDF, i.e. by trade intermediaries for on-lending to individual farmers, independently employed and entrepreneurs of micro enterprises - individual entrepreneurs (Loan Type 1), small enterprises (Loan Type 2), and micro enterprises (Loan Type 3). There are no significant reasons to exclude any target group or segment of a target group, which means that there would be an absolute unity between the target group for MEDF credits and the target group for MEDF guarantees.

The same applies to the target area - there is no special reason for additional regionalisation of the guarantee scheme, i.e. the target area would again be the whole territory of the country. This will significantly facilitate the administration, as well.

D.4. CRITERIA AND CONDITIONS FOR ISSUING GUARANTEES

a) Efficient supplementary collateral

The difficulties SMEs face while obtaining credits from the formal banking system usually are due to: 1) a lack of operational possibilities to repay the obligations, 2) performance, and 3) their capacity for credit. In general, their weaknesses concern the small capacity of assets and liabilities of the credit borrower, the fragile financial structure, inadequacy of capital and lack of collateral. The high level of operational costs and the high risk are the main two reasons that deter the banks from approving credits to SME, or they compensate for this by strict and large demands on collateral.

Through the GF, MEDF intends to support those SMEs that succeed to overcome the gap of insufficient collateral after the guarantee is issued.

b) Policy of risk sharing

The risk sharing will be one of the policies of MEDF in establishing a GF with partner banks. The GF will certainly take on a larger portion of the risk, but a small part needs to remain for the partner banks. The risk sharing policy has the following advantages:

- Risk sharing obligates the partner banks to be careful with the assessment of the credit request, in order to reduce the credit risk, in this case shared between the partner banks and MEDF.
- Risk sharing creates partner relations between the banks and MEDF.
- With risk sharing, MEDF acts as an additional provider of collateral, thus improving the readiness of partner banks to approve credits to SMEs.

The usual range of risk that is taken on by the guarantee fund is from 50% to 90%. Exceeding this bottom limit of 50% would almost eliminate any interest among the banks and would raise the question of the purposefulness of this fund. Exceeding the upper limit of 90% would mean a too small responsibility of the banks in the whole process, thus threatening the sustainability of the guarantee scheme. Furthermore, the limits of 50% and 90% seem inadequate in this regard. Therefore, the percentage of risk sharing should be somewhere between 60% and 80%, whereby the concrete choice could be made depending upon the results of the talks with the banks.

The percentage of risk sharing could be fixed for all kinds of guarantees, or there could be a variable part, depending upon the type of credit guarantee, i.e. the beneficiary (per type of loan), or the credit rating of the SME, or the performance of the partner bank, or some other criteria. Such a variable part may be aimed at promoting some desired structure of issued guarantees. However, even if it is assumed that there is full justification of these goals, simplicity in administering the same percentage in risk sharing still seems to provide a superior solution, especially at the start of operations.

c) Reimbursement for the guarantees

It is usual that SMEs pay a price for the lack of collateral. Thus, SMEs themselves are stimulated to behave responsibly when they decide to apply for a guarantee, and the guarantee would be reserved for those SMEs that realistically do not have enough collateral. The partner banks may collect the reimbursement for the issued guarantees to SME beneficiaries of those guarantees, for the account of the GF and MEDF.

The level of reimbursement should be reviewed from two aspects: as a motivational element and as coverage of the expected losses.

The motivational element is perceived in the various effects of the relatively low and relatively high levels of reimbursement upon the behaviour of the beneficiaries. In the situation of relatively low reimbursement, beneficiaries are relatively highly motivated to apply such an instrument and to save in regard to the collateral (thus preserving that same collateral eventually for some other credit, and they minimize the risk of their own property); in the extreme case when the price of the guarantee would be below the price for establishing a mortgage, there is even a price motive to do this. On the other hand, when the price of the guarantee is relatively high, the beneficiaries would be strongly de-motivated to substitute the collateral with guarantees, and the guarantee would be reserved only for beneficiaries that really do not have collateral (and the inevitable beneficiaries with fraudulent goals). Of course, the extreme option is for the price to be prohibitively high and to eliminate any kind of demand.

The aspect of covering losses is reflected in the effort that the reimbursement for the guarantee should serve as a source of coverage for expected losses. In contrast to the "war risk", when we talk about the risk of insufficient collateral, the losses are an actuarial category and some parameters can be determined. Thus, the losses of credits that are covered by such a guarantee cannot be lower than the losses of the overall supply of credit by the bank. Furthermore, these

losses should be slightly higher because of the relatively higher objective risk factor caused by the insufficient collateral (which at the same time also reduces to some extent the debtor's readiness to repay, and eliminates collateral as a source of full collection of the credit). If we consider that this difference in risk will be compensated by the risk sharing, then the reimbursement should be approximately at the level of average credit losses of the partner banks (calculated over new credit supply). An alternative approach is that MEDF will be prepared in advance for "programmed losses", as a price for improving the access to credit for insufficiently collateralised applicants; however, this is in contrary to the principle of sustainability and ability to replicate, and therefore it should be rejected.

Similar to the risk sharing issue, the reimbursement may vary depending upon a series of criteria; nevertheless, it is recommended that the reimbursement should be standardised, especially at the start of operations.

The reimbursement may be expressed as a one-time fee when the guarantee is approved, or as a supplement to the interest, or a combination of both. The simple one-time fee does not seem to be the best solution in view of a just price and securing sufficient coverage against losses. The other two solutions are quite acceptable, with a small priority towards the combination as the most practical (as well as most abundant solution).

d) Prohibition of refunding old placements with newly approved credits

The partner banks should not be allowed to cover old placements with newly approved credits, guaranteed by the GF, and this should be clearly stated in the formal agreements and less formal communications.

e) Credit procedure

The partner banks are expected to devote equal attention in the implementation of the credit procedure, regardless whether this concerns guaranteed or non-guaranteed credits. The overall procedure is designed in a manner that pays attention to retaining the elements of bank responsibility for approving good credits.

In the case of maturity of guaranteed credits, and when the company is not able to meet its obligations, the bank should warn the borrower and eventual guarantors about repayment of the credit, or otherwise, undertake all measures available for collection of the credit, in conformity with the established procedures for collection of matured and unpaid claims. Even if the credit has been repaid by means of collection of the GF guarantee, the partner bank should continue to execute its procedures for collection of the matured claims from the borrower.

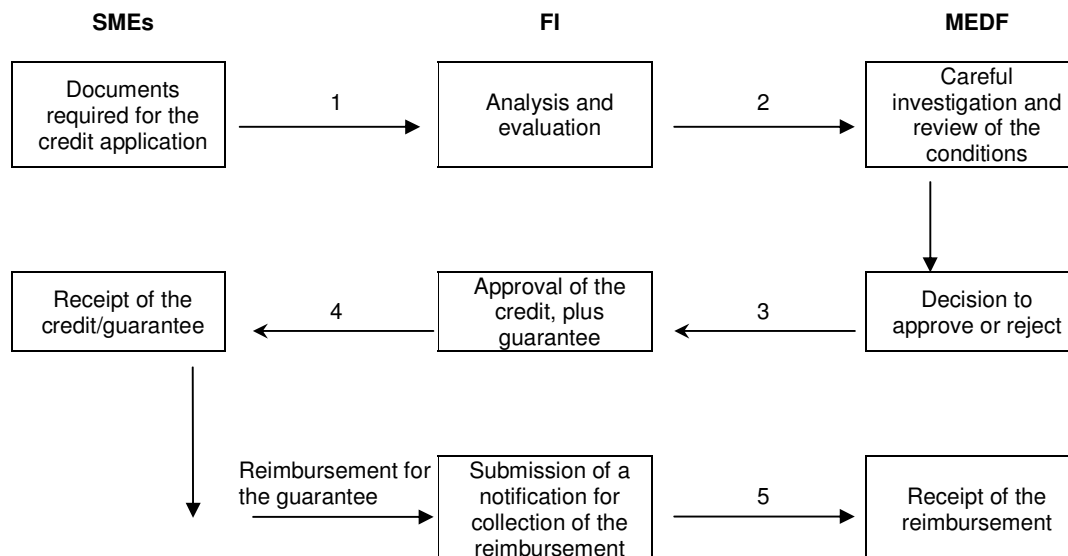
D.5. PROCEDURE - MECHANISMS FOR ISSUING A GUARANTEE

MEDF will use the branches and branch offices of the partner banks for issuing credit guarantees.

Having in mind the existing set-up for implementation of the MEDF credit programme through accredited banks, submission of a request for a guarantee would go through the partner banks. Other remaining options for application (directly to MEDF, other financial institutions, etc.), should not be treated at present.

The credit guarantee application is usually reviewed and processed in the regular credit procedure at the accredited banks. The partner banks will recommend the application to MEDF for issuing the requested guarantee only if the application concerns the need for additional collateral or for covering war risk. The referral of the guarantee application would be conducted together with the referral of the request for financing the credit.

Diagram of the regular procedure



Clarification:

Phase 1: SMEs submit documentation for the credit application to FI (financial institutions - accredited banks).

Phase 2: If the FI encounters a case of a lack of collateral, and the application meets the conditions and criteria, FI starts with the initial credit analysis and evaluation of the application, and then refers the relevant documents to MEDF.

Phase 3: After the usual investigation and review of the credit application by FI, plus the separate review regarding the offered and valued collateral, MEDF will notify FI whether it approves the credit and/or guarantee, and it will submit appropriate individual credit agreements.

Phase 4: After the notification is received, FI starts to approve the credit, according to the usual procedure, with the only change that the credit agreement contains the relevant changes regarding the guarantee.

Phase 5: FI submits the notification for collection of the reimbursement for the guarantee, and transfers the reimbursement collected from the borrower to MEDF's account.

D.6. RISKS

a) Insufficient interest among the banks

This kind of insufficient interest can appear because of an insufficient demand from the beneficiaries (for example, because there is no need or the price is too high), or because superior alternative guarantee mechanisms exist. The existing insufficient supply of guarantee mechanisms for lack of collateral solves this problem from all aspects, except if the guarantee price is prohibitive. Namely, the needs of the beneficiaries are evident, and the existing supply is definitely insufficient, let alone superior.

The real manifestation of this risk would be if the banks are eventually not prepared at all to accept the insufficient collateral, even if there is a partial guarantee. The possible reason would be conceptual disagreement with such supply of credit, combined with the percentage of risk sharing that would be perceived as insufficient to cover the actual risk. In this case, the solution for this risk is no so much in increasing the percentage in risk sharing to the level that is comfortable for the banks (because this would undermine the sustainability of the guarantee mechanism), but rather in

finding a good optimum. In final instance, the essence of the guarantee fund is not only to improve access, but also to encourage banks to "experiment" with supply of credit even with a less strict criterion, as a precondition for eventual change in their practices.

b) Utilisation of the guarantee fund for already approved credits

Here again is a traditional risk that the banks will not use the guarantee fund for new risks for approving new credits, but rather for covering existing risks from existing (bad) credits.

This certainly would be very attractive to the banks. However, this guarantee scheme is second to the existing MEDF credit line, which implies refinancing of actually new credits. This is stressed also by the fact that the basic credit form which the bank submits to MEDF requires a statement by the bank about the existing level of claims for that client, making this even more difficult. This all means that the utilisation of the guarantee for these purposes would be a serious breach of the basic framework agreement, and not only the other contractual acts that would be concluded between MEDF and the partner banks for the implementation of the guarantee fund. In such a situation it is believed that the long-term benefits from the partnership agreement would be more important to the banks than the one-time benefit from covering existing bad credits.

c) Utilisation of the guarantee fund for structuring credit risk

One kind of rational utilisation of the guarantee mechanism is that a larger exposure of one client towards the bank can be structured so that the collateral can be concentrated in the part of the exposure that is financed and covered by the bank, and the remainder is "parked" under the guarantee mechanism. This improves the risk profile of the bank, at the expense of the guarantee fund. This enables the bank, in the case when the credit would become problematic, to also restructure its part of the credit, and to liquidate immediately the part that is covered by the guarantee.

This kind of "competition" should be regulated explicitly with the contractual acts. Partial refinancing is completely in order, and it should remain a practice (i.e. it may not be excluded), but this partiality may not extend also to the collateral. There are two possible ways to regulate this issue: a) framework collateral - the complete collateral would serve to cover the overall exposure; b) definite collection - the MEDF-bank relationship would be considered as fully liquidated only after the overall bank-client relationship is liquidated. Neither of these two ways is comprehensive and completely satisfactory, and it is possible that the only diverting factor would be the partner relationship, and the only procedure that would support this would be a direct case by case review.

d) Utilisation of the credit fund only as additional protection

The guarantee fund can be used not for crediting marginal credit requests, but only as supplementary collateral for credits that would have been approved anyway. Thus, the guarantee fund would be implemented, security would be even better, but the basic goals of the guarantee fund would not be achieved.

The only direct control over this risk is the guarantee price, which means a relatively more expensive credit, and bears a certain need for the bank to justify this to the client. There is also an indirect control by relying on the rational banking reasoning that this kind of guarantee supplement would be reserved for cases that have a concrete need for this. Finally, the best control is to request in the guarantee application form to list all collaterals and their evaluated value.

e) Utilisation of the guarantee fund for retaining/increasing the deposit

In a situation where the guarantee fund is implemented through a deposit with the bank, one bank may rationally decide to use this fund regardless whether this is necessary, only in order to acquire a useful long-term deposit.

This risk is unavoidable in the cases where the guarantee scheme is implemented by means of a direct deposit. This may be overcome by substituting the deposit with a bank guarantee (as in the case of the Guarantee Fund). This may also be controlled through the mentioned form for the collateral. Nevertheless, it seems more reasonable at the beginning to use a guarantee by placing a deposit very carefully, and to expand it only after the concrete behaviour of the banks is determined.

f) Exhaustion of the guarantee fund because of excessive damages

If the guarantee fund has losses that are higher than the accumulated commissions minus operating costs, then we have a sustainability problem, because this would gradually eat into the fund until it is completely gone and there would be a need for recapitalisation.

This risk can be controlled only in regard to the watchfulness for preventing eventual fraudulent behaviour by the banks, which is not very probable in the credit programme that relies upon accreditation and careful selection of partner banks. If the fraud factor is excluded (and we ignore the luck factor, as well), this risk cannot be controlled because it depends upon something that is completely outside of MEDF's reach: whether a bank can develop a good procedure for credit approval with insufficient collateral, or not. In the extreme option, the existing of a guarantee scheme for insufficient collateral means to entice the bank to use a new credit product of insufficiently collateralised credits, and there is no possibility to foresee what could be the final outcome of this new endeavour.

On the other hand, if the guarantee fund has no losses, respectively it has losses smaller than the normal bank losses, then maybe sustainability is secured, but the question of justification is raised. Namely, small losses may mean that an inverse selection of risk appeared at the guarantee fund, i.e. it is used only for already secure credits. Of course, the best outcome is to conclude that the guarantee fund "proved" that the credits with a more careful analysis of risks and without satisfactory collateral are better quality than credits where the satisfactory collateral made it impossible to do a better and full credit analysis. In any case, it will not be an easy task to conduct the evaluation of the final effects of the guarantee fund, and these effects will not be readily visible or readable.

D.7. EXIT STRATEGY

In the absence of any precise statistics, the most frequently foreseen exit for the guarantee funds is that they are exhausted from excessive damages, especially when the percentage of risk sharing is higher. A second frequently used exit is termination because it is not used, primarily because the interest among the banks is too small, motivated either by the small risk sharing, or by excessive losses in this part, or by the lack of certainty in the implementation of the guarantee. The "best" exit for a guarantee fund - to become unnecessary because the banks become prepared to approve insufficiently collateralised credits without demanding additional guarantees - is almost only theoretical, because the guarantee risks do not resolve the current imperfections of the market that can be corrected easily.

In the concrete case of the guarantee fund, linked with the MEDF credit programme, a possible exit is also when the alternative guarantee funds become operational to the level where the additional MEDF guarantee fund would not be needed.

Up to the time when abundant and efficient guarantee funds are established, the MEDF guarantee fund would exist, and it would balance between the two risks of exhaustion and irrelevance. Objectively speaking, this balance is difficult to sustain on the long-term, and it would be normal to expect the occurrence of one of the two risks, causing the end to the guarantee mechanism. In fact, the successfulness of the guarantee mechanism would not be measured so much by the time frame it remains in place, but rather by the extent to which it manages to open up possibilities for a more flexible supply of credit by the banks.

E. OPERATIONALISATION

E.1. PROCEDURE

The guarantee funds represent a component of the MEDF strategic plan for the period 2003-2006, and as such, they can formally be implemented within the framework of this plan and during this period.

Nevertheless, before starting it is desirable to hold a preliminary discussion within the framework of the Board of Trustees, which would review once again the purposefulness and justification of both guarantee funds separately, based on the prepared study. This discussion could result in a separate strategy and framework platform for the selected guarantee funds, which would repeat the basic principles and would provide guidelines for the future procedure.

Without prejudice to the conclusions that would result from the Board of Trustees discussion (and without previous prejudice on the need itself to hold a Board of Trustees discussion), it seems that the optimal sequence of events is as follows:

- initial talks with the bank, based on an eventual strategy and/or framework platform, or just on the study;
- reviewing again the strategy/platform/study in light of the initial talks;
- preparing draft agreement acts (including the procedures and forms), which would regulate the guarantee funds;
- submitting these documents to the banks, as a basis for negotiations;
- carrying out concrete negotiations with the banks;
- finalisation of the agreement acts based on these negotiations;
- formulating a special financial rulebook by MEDF for the guarantee funds;
- formulating internal MEDF procedures for handling and monitoring of the guarantee funds;
- supplementing the monitoring system with the component for monitoring the guarantee funds.

It does not seem sensible to have a special presentation of the two guarantee funds, regardless of the unique promotional value this could have. Even though they should not be hidden or not mentioned, both guarantee funds are primarily an issue in the MEDF-bank relations, and the clients would be introduced to them upon the initiative of and identification by the bank. Hereby, they can be mentioned freely in the various contacts with eventually interested clients.

The grounds for this opinion are that clients with insufficient collateral will contact the banks, anyway, while in regard to war risk, this risk is not the only reason for poor access to bank credit in risk areas; thus, stressing this war risk will only give false hope of radically improved access to credits for clients in those regions.

After some time, shorter or longer, both guarantee funds would become sufficiently well known. Under those circumstances, public promotion is not only possible, but it would actually already have been conducted. However, initial conclusions about their operation would already be available by that time, which would facilitate their public presentation.

E.2. REQUIRED RESOURCES - HUMAN, MATERIAL AND FINANCIAL

The required resources are significantly different in the specific phases of the guarantee fund:

- a) in the design phase (start-up expenses):
 - formulating the procedure for implementation of the guarantee funds;
 - other phases provided in the chapter on procedures (or other selected phases);

The required resources in this phase consist of appropriate time (hours) by management and officer, as an internal opportunity cost, and very modest external costs for private expertise on the draft agreements and eventually, a very small expert support in the formulation of the platform and preparation of the draft documents. Material costs are neglectable.

- b) in the implementation phase (approval of guarantees):
- review whether conditions are met, prior to approving a guarantee;
 - changing the interest rate in the agreements and in the depreciation plan, as well as the one-time fee;
 - continuous assessment whether the level of risk and the effects from the guarantee funds are such that MEDF should stop with one of the guarantee funds.

During the implementation phase, the only real expense is the short review of the justification from the application for guarantee coverage, to test the logic of the stated facts of the credit in risk areas (for war risk), and the conditions for issuing a guarantee (for lack of collateral), which is very small. Once the changed interest rate and one-time fee are inserted into the agreement and the depreciation plan (which again is a question of minutes), the whole scheme functions without any changes in regard to "regular" credits. Therefore, the material costs are almost non-existent. In the linked phase of monitoring the guarantee funds, there will be a need for both management and officers to spend time on the regular monitoring of operations. Even though there is a concrete expense in this, it still does not require special budgeting or analysis.

- c) in the phase of guarantee activation (if a risk event occurs):
- verification of the truthfulness of the bank statement on the risk event.

The following additional steps appear for the guarantee fund against war risk:

- deciding on the way the occurrence takes place that is best for the interests of MEDF;
- negotiations with the bank on how to proceed further;
- establishing a special monitoring system for such credits;
- eventually take over the function to lobby for execution of the collateral;
- eventually take over the function of ownership and governance over the collateral, up to when it is sold.

This is the most expensive phase, both in regard to the required management and officer time, as well as to the external expenses, especially if the collateral or the right over it are accepted in ownership and governance. This "expensive" phase could become far less expensive if agreement is reached for MEDF to bear the direct expenses linked with the management of the collateral, while the bank would not invoice the time spent by bank personnel.

F. ANNEXES

ANNEXES TO THE STUDY

- Detailed description of the existing guarantee schemes in Macedonia
- Guarantee funds in the countries of the region
- Tabular database of guarantee funds in the world
- Description of the database of guarantee funds in the world
- Detailed description of the MIGA guarantees

ADDITIONAL MATERIALS

- Draft Law on a Guarantee Fund (Macedonia)
- Draft Law on a Guarantee Fund (Serbia)
- Database of guarantee funds in the world
- Description of the Turkish guarantee fund KGF
- Description of the Czech guarantee fund programme
- Evaluating Credit Guarantee Programmes in Developing Countries
- Credit Guarantees: An assessment of the state of knowledge and new avenues of research
- Guarantee Funds and NGOs: Promise and Pitfalls
- List of literature on guarantee funds