NABARD

RURAL PULSE

NABSANRAKSHAN FOUNDATION DAY SPECIAL ISSUE*

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Credit Guarantee- A De-Risking Tool in Rural Finance

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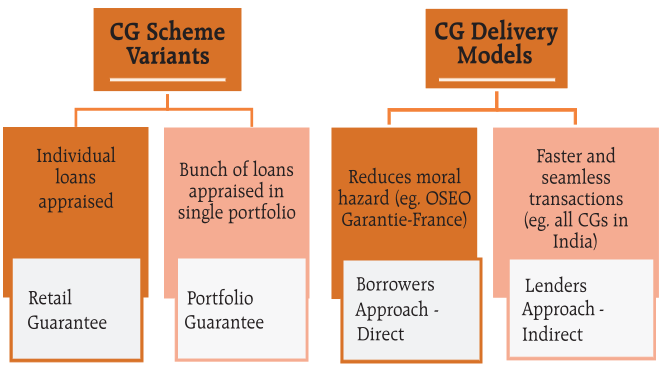
Rural credit facilitates production through working capital and investment loans. However, the outreach is limited as hardly 35% of rural households have availed bank credit, as per the All-India Debt and Investment Survey (AIDIS), 77th round of NSO[2]*. The low outreach is partly due to perception of risk by banks in lending to rural people and asymmetric information, which needs to be addressed. Providing credit guarantee cover to relatively high-risk tag loans would help banks to extend credit to sub-prime but desirable categories. Borrowers, on the other hand, can get first-time loans or higher amount of repeat loans at relatively cheaper rates of interest as banks do not charge risk premium due to credit guarantee. Thus, credit guarantee can lead to higher flow of funds to the needy besides unleashing inclusive development through inclusive finance. This brief paper elaborates on the credit guarantee mechanism and application in the Indian context through the newly incorporated subsidiary of NABARD, NABSanrakshan taking the use case of FPOs lending.*

1. Credit Guarantee Mechanism

Credit Guarantees (CG) are the "Access to Finance" mechanisms provided as a risk sharing instrument for lenders and are aimed to improve flow of credit in borrower segments which are normally perceived to be risky by lenders. Credit guarantee mechanism involves three main participants - borrower, guarantor and lender. Guarantee is a traditional method of assuring the lender about the safety of his money lent to a given borrower. A guarantor (here, the credit guarantee organisation) assures to make good a proportion of the borrower's debt to the lender in case of default.



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NABSanrakshan Trustee Private Limited, a wholly owned subsidiary of NABARD has been established on 13 November 2020 as a Credit Guarantee Company dedicated to serving agriculture and rural sector. Currently, NABSanrakshan is managing two Credit Guarantee Schemes (CGS) i.e. CGS for FPOs and CGS for Animal Husbandry and Dairying (AHD). The broad features of CGS for FPOs and AHD are:

Item	Credit Guarantee Scheme for FPOs Financing	Credit Guarantee Scheme for Animal Husbandry and Dairying
Credit Limit	Max. ₹2 crore (Working Capital/ Term Loan)	Within the MSME defined ceilings (Term Loan)
Guarantee Cover	Upto 85% of the sanctioned amount, max. ₹1.5 crore	25% of the credit facility
Annual Guarantee Fee	Upto 0.85% of sanctioned amount	1% of the sanctioned amount
Eligible Lending Institutions	Scheduled Commercial Banks, Co-operative Banks NEDFi etc.	Scheduled Banks
Eligible Borrower	FPOs (Agri based)	FPO, Pvt Company, Sec. 8 Company, Individual Entrepreneur, MSME

* Special Commemorative Issue on the 2nd Foundation Day of NABSanrakshan Trustee Private Limited, 13 November 2022

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1 DGM/ Senior VP, NABSanrakshan Trustee Pvt Ltd.; AM/ VP NABSanrakshan Trustee Pvt Ltd. and AM, DEAR, NABARD. Guidance and inspiration received from editorial board members and Shri Pankaj Kumar, GM/CEO, NABSanrakshan Trustee Pvt Ltd are gratefully acknowledged.

2 All-India Debt and Investment Survey (AIDIS), 77th round of the National Sample Survey (NSS), January to December, 2019, MoSPI, GoI.

Thus, credit guarantee mechanisms can address the financing challenges of information asymmetry, risk management and collateral needs by reducing the financial loss suffered by the financial institutions in the case of defaults. The availability of a risk mitigation instrument in the form of CG also encourages the lending institutions (LIs) to extend cheaper credit.

Credit Guarantee Scheme: Value Creation

Guarantor (Government)	Lender	Borrower
• Creates eco-system for bank lending to the vulnerable • Livelihood enhancement • Promotes financial inclusion & the sector	• Reduced risk burden and quality portfolio • Saving on capital provisioning • Reduced default ratio	• Better income generating opportunities • Overcoming collateral requirements • Access to cheaper funds

2. Types of Credit Guarantee Schemes (CGS)

Types of CGS	Definition
Public Guarantee Schemes	Established by public policy. Managed by a private organisation or an administrative unit of the government. Example: CGS for FPO Financing (NABSanrakshan).
Private Guarantee Schemes	Generally funded and operated by the private sector including banks and chambers of commerce. Such schemes are operational in Germany, Italy, Brazil, etc.
Mutual Guarantee Schemes	Private and independent organisations formed and managed by borrowers. Example: CONFIDI in Italy, SIAGI and SOCAMA in France.
International Organization	Bilateral or multilateral government initiatives. Example: ADB's Partial Risk Guarantee Scheme.

In India, the CGS are mainly Public Guarantee Schemes which offer possibility of cross-subsidizing guarantee fees and helping lenders in capital conservation. Further, banks are permitted to apply zero risk weight in respect of claims on sovereign guarantees, as per RBI's Prudential Norms on Income Recognition, Asset Classification and provision pertaining to Advances. The corpus is usually from GoI and in certain cases by State Govt. or Financial Institutions like NABARD, SIDBI, etc. The guarantee fee is subsidised to make the CGS more attractive.

3. Crucial Terminologies in the Credit Guarantee Process

The following key terminologies/aspects help us understand the heterogeneity amongst the several CGS operational within and across countries.

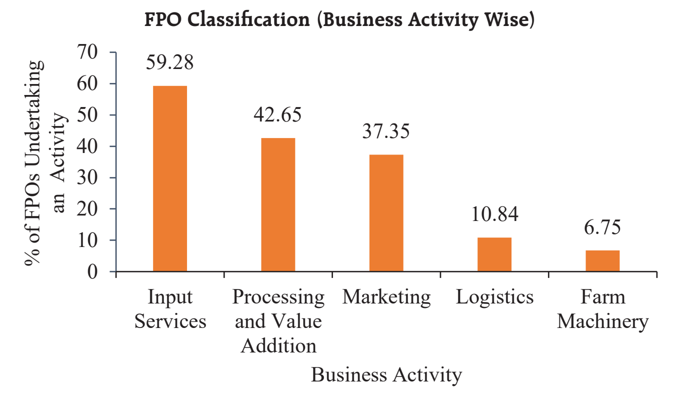
Leverage Ratio	Ratio of total outstanding guarantees to the corpus of the guarantee fund. It is critical in the risk management and financial sustainability of CGS. As a norm a leverage ratio of ten is often accepted.
Coverage Ratio	Extent to which a defaulted loan is guaranteed and vary depending on the type of the loan, the maturity of the loan, and the riskiness of the loan. Coverage ratio should strike balance between incentivising LIs and preventing moral hazard.
Pricing	Two common types of fees include up-front fees and annual guarantee fees (AGF), which often coexist. In some cases, AGF are variable and related to type of loan or guarantee or to the borrower's risk profile, which also impacts incentives of borrowers.
Risk Sharing Order	In the case of default of guaranteed loans, CGS makes payment to the lenders. There are two ways in which CGS shares the loss: on a 'first-loss' basis or 'pari-passu' basis. On a first-loss basis, CGS bears the loss until covered amount; on a pari-passu basis, CGS bears the loss on an equal pro-rata basis.
First Loss Default Guarantee (FLDG)	The digital lending which has seen a stupendous growth in the recent times, typically has a Bank and a Lending Service Provider (LSP), most likely an NBFC coming together to extend credit services. FLDG is a credit risk sharing arrangement wherein the LSP provides certain credit enhancement features such as first loss guarantee up to a pre-decided percentage of loans generated by it. From the LSP's perspective, offering FLDG acts as a demonstration of its under-writing skills whereas from the lender's perspective, it ensures LSP's skin in the business.

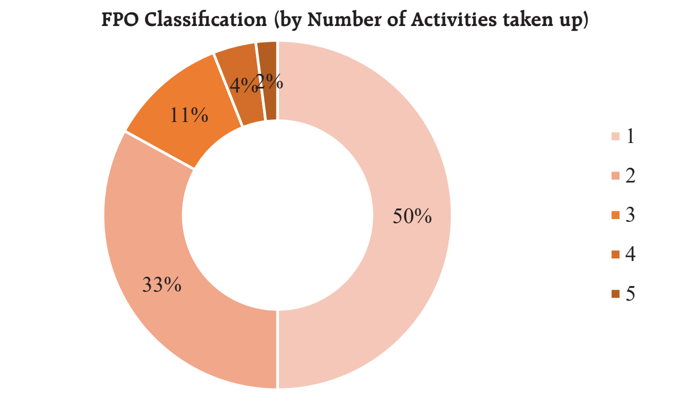
Credit Guarantee Scheme: Performance Indicators

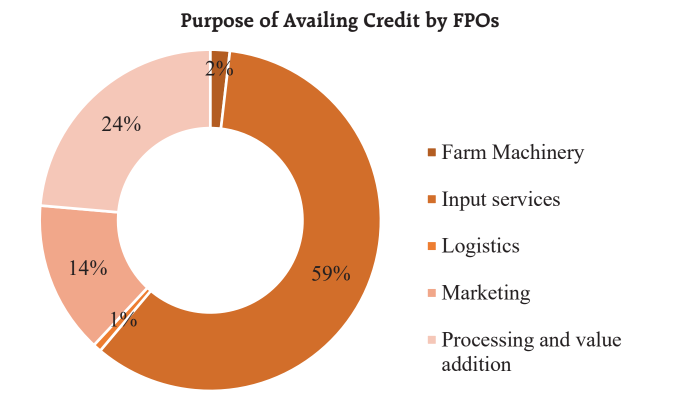
Net Loss Ratio	Operational Efficiency	Guarantee Portfolio at risk
• Ratio of payment of claims to outstanding guarantees • Lower ratio indicates sustainability of guarantee operations	• Transaction cost per unit of currency guaranteed • Average time taken to issue guarantee/ settle the claim	• Ratio of total guaranteed portfolio overdue to total guarantee portfolio • Lower ratio indicates better portfolio quality

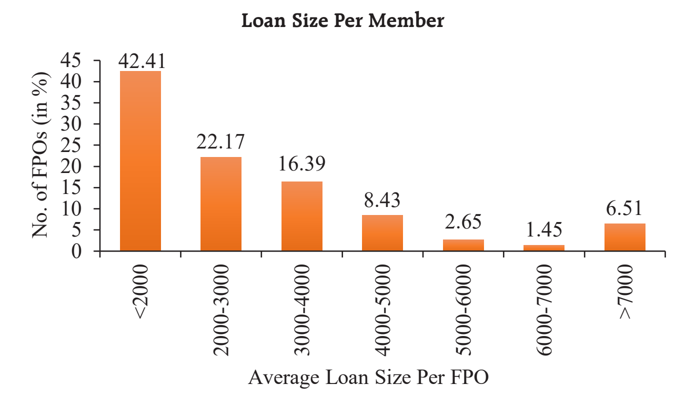
4. Credit Guarantee Scheme: Experience Through FPO Scheme

28 Dec 2021 launch date of CG for FPOs	
415 FPOs covered (as on 15-10-2022)	**3 lakh** members with 85% small & marginal
₹20.40 lakh average loan size/FPO	**₹17.15 lakh** average guarantee cover
₹84.69 crore loans covered	**₹71.19 crore** total guarantee cover
80% of project cost covered through loans	**₹64.32 lakh** cumulative nominal fee
FPO classified as per	
(1) Business Activity:	**(2) Activities pursued:**



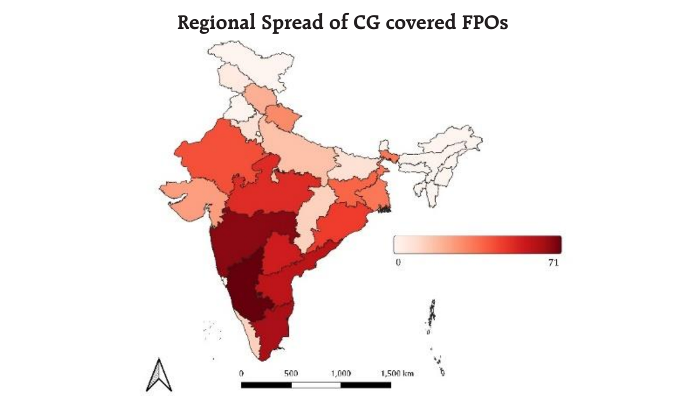






- FPOs are spread across 193 districts in 19 States but are primarily concentrated in the Southern and Central Regions of India.
- 403 FPOs were located in plains and 12 FPOs in hilly areas.
- 92% of the FPOs are registered under the Companies Act and the remaining 8% registering themselves under the Co-operative Societies Act.

Source: Data mainitained by NABSanrakshan



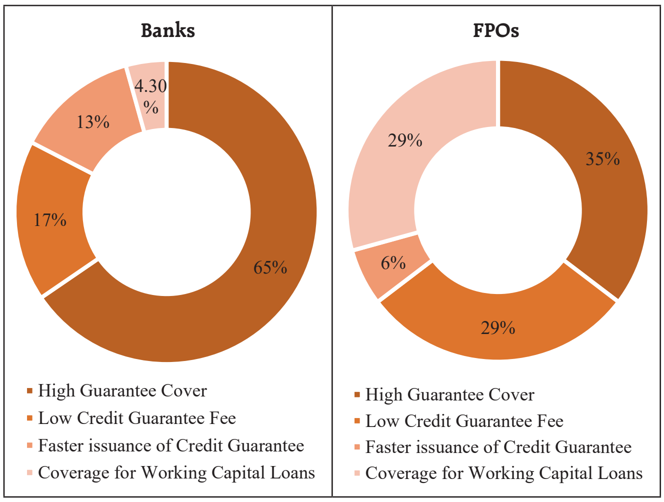
5. Beneficiary Feedback on the CG Scheme

In order to ascertain the awareness regarding CG Scheme for FPOs amongst LIs and FPOs as well as understand the impediments and usefulness of the Scheme, a quick feedback survey about the Scheme was developed and canvassed online (through MS Forms). A total of 40 respondents (23 Bankers + 17 FPOs) participated in the survey providing us useful insights about the Scheme.

Key Findings

Banks	FPOs
100% bankers aware about CG Scheme	**71%** FPOs aware about the Scheme
100% bankers feel CG encourages credit extension/expansion	Loans of **76%** of the surveyed FPOs covered under CG
60% of bankers availed CG	**70%** of the surveyed FPOs feel CGS has enabled them in availing loan

Important Feature of CG Scheme



6. Challenges in Credit Guarantee

Some of the CG design and operational challenges are:

- Credit guarantee mechanisms are likely to cause moral hazard at least in two dimensions.
    - o First, the borrower is likely to have a high incentive to fail, because the loss as a result of failure and the need for collateral is covered and filled by credit guarantee.
    - o Secondly, the LI may lack the impetus to maintain a strong credit rating, to oversee the quality of the secured borrower's credit and to collect the debt repayments.
- The operational challenges include lack of mechanism to ensure non-acceptance of collateral by the LIs, delay in marking NPAs, non-remittance of recoveries to the Guarantor, etc.
- Considering the demand for credit guarantee de-risking mechanism, the corpus requirement for running the CGS is very large. Over leveraging of the available corpus is a constant threat to the sustainability of the CGS.
- Suitable benchmark to reflect the correct position of leverage on the corpus fund considering outstanding guarantees, claims rejected on technical grounds and likely to be re-lodged and estimated second claims are difficult to identify.
- The relatively long maturity of the guaranteed credit portfolios and the lack of counterfactual evidence, the measurement of the performance and the impact of the CGS is technically challenging.

7. Way Forward

The importance of focussing credit on small farmers who are at the epicentre of rural distress and migration can never be underestimated. Better access to institutional finance at competitive rates with a comfortable payback period can ease the burden of financing activities. The agriculture and rural sector has greater challenges due to its unique socio economic position. The issue has been further compounded by the impact of climate change in recent times. Credit guarantee focusing in these areas with adequate corpus support from GoI/ State Government or other institutions on the lines of MSME sector can help in alleviating challenges in availing credit from formal channels. Further, building awareness about such financial product among the LIs and the borrowers can further help in enhancing the credit outreach and absorption at the grassroot level.

Credit guarantee schemes can be an effective way to provide access to finance. An effective credit guarantee scheme with the right mechanism and risk management process can generate positive additionalities and would be a desirable step towards achieving "Atmanirbharta in Krishi".

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