RAISE-FS issue brief #05

Impact of Liquidity Challenges on the Implementation of Guarantee Fund Scheme: Implication on access to finance for SMEs and farmer organizations

This brief presents the overview of factors that impede the implementation of the guarantee fund scheme and gives possible recommendations for improving access to rural finance.

Introduction

Finance is one of the most important inputs in the agricultural sector of Ethiopia. Farmer organizations and SMEs face severe challenges due to unavailability of credit at reasonable interest rates. The low availability of finance to these sectors is the high-risk perception of banks and lack of hard collateral in lending to farmers and MSEs. According to USAID-DCA (2017) loan guarantee impact brief, agricultural lending made up only 8 percent of the total value of outstanding loans in Ethiopia. Improved access to financial services plays an instrumental role in realizing sustainable economic development of the country. However, formal financial institutions (Banks and MFIs) are inefficient in soliciting funds and availing credit facilities to farmers and small and medium enterprises (SMEs) because of liquidity problems and risk factors (Schrader et al., 2021). Therefore, SMEs, primary cooperatives, and farmer cooperative unions often face working capital shortage to support farmers for their production; cooperatives and unions for aggregating and marketing; and SMEs investment capital for business startups or expansions.

Understanding the access to credit challenge, BENEFIT-SBN demonstrated the ‘guarantee fund’ scheme with the Cooperative Bank of Oromia (CBO) and Anbasa banks in Tigray and Abay Bank in Amhara. This financial arrangement, (70:30 percent Bank: Project risk sharing) was tested to partially relieve the hard collateral requirements of banks in providing credit to farmer organizations and SMEs. The innovation attracted private banks to enter into the agricultural sector and provide credit to SMEs, farmer organizations and smallholder farmers through their organizations. Based on the evidence generated, there was a plan to scale up the scheme at national level. However, the scaling-up effort couldn’t move forward as planned. Thus, this issue paper presents the overview of factors that impede the implementation of the guarantee fund scheme and give possible recommendations for improving access to rural finance.

Objectives

The objective of this review work is to generate evidence on policies, regulations and directives that impede guarantee fund implementation to farmers and small and medium scale enterprises in Ethiopia.

Specific objectives include:

- Identifying the main barriers of finance to SMEs and the farming community
- Finding the supportive or prohibitive policies and directives, and
- Forward possible recommendations for improving the financial challenges to SMEs, farmer organizations and farmers through the guarantee fund scheme.

Methodology

To assess the access to finance limitations to SMEs, farmer organizations, farmers, rural women and youth, the study used a literature review of financial policies, regulations and directives; published materials; unpublished study reports and face-to-face discussions with development partners and loan department staff of selected commercial banks.

Financial Institutions

The financial sector is crucial for investment, job creation and private sector growth; reducing poverty and meeting the national development goal. The sector involves formal and informal actors. The National Bank of Ethiopia (NBE), Development Bank of Ethiopia (DBE), commercial banks (both private and public), microfinance institutions (MFIs); savings and credit cooperatives (SACOs), and insurance companies are formal financial service providing organizations. These institutions are mandated by proclamation No. 592/2008 to mobilize funds within and outside the country from savers and depositors and channel these to various sectors of the economy to create wealth. According to the NBE (2022) report, there are 30 commercial banks with 8,250 branches operating across the country. The total deposit is estimated at over $30 billion. Out of this amount, over $25 billion is loaned. Thus, the remaining 5 billion USD in liquid

asset forms at the 30 banks is small enough to cover their liquidity requirements. Moreover, the liquidity situation is worsening due to significantly declining deposits and increased cash withdrawals.

Financial policies, regulations, directives and their implications

The Ethiopian government has been putting in place different financial policies, regulations and directives to govern monitor and address challenges arising in the financial sector. Proclamation No. 592/2008 authorizes NBE to regulate and control financial institutions whether they meet their debt obligations without realizing great losses (NBE 2013/14). To safeguard the depositors' money, the Government enacted a 'depositors' insurance fund scheme through Regulation No. 482/2021. The objective of this scheme was to enhance the stability and security of the country's financial sector by safeguarding customers and creating a deposit insurance fund that can reimburse depositors in case of bank failure. The regulation compels commercial banks and MFIs to contribute an initial premium fee of 0.05% of their total deposits, and an annual premium of 0.3% of the four-quarter average deposit balance (Regulation No. 482/2021). This regulation may also drain some amount of cash from banks, impeding the financial institutions' lending performance.

The obligation to purchase DBE Bond, where commercial banks are obliged to invest a minimum of 1% of their outstanding loan and advances in the bond until the aggregated bond holding equals 10%. Though DBE bonds mature in 3 years and generate 9% interest rate, it is much lower than banks' average lending rate of 14.5% and the annual inflation rate of over 30%. The Treasury bond: for any amount the banks' loan-out, they have to purchase a Treasury bond equivalent to 20% from the NBE. Investments in bonds drain the banks of cash predisposing them to liquidity shortage (Directive No SBB/81/2021).

The NBE Directive numbered SBB/57/2014 is another provision that partly locks down access to finance to SMEs and farmers. Banks are restricted by this directive to stop granting new or additional loans or credit accommodation to any person without prior written approval of the National Bank if they do not have reserves above 15%. The prohibiting directive coupled with reserve depletion faded banks' appetite to loan SMEs. The current lack of interest of banks to give credit to loan seekers is an indication of commercial banks' failure to meet the minimum obligatory liquidity requirement. Though the measures target the overall financial sector and economy, they significantly impacted the scaling up of the guarantee fund scheme that tries to ensure better access to SMEs, women, youth and farmer organizations in rural areas. Until today the country does not have a policy directive on the credit guarantee scheme to farmers, micro, small and medium enterprises (MSMEs). Consequently, access to finance for SMEs and farmers remained a major challenge due to the lack of an independent institution that develops financial services and products that meet the needs of the agriculture sector. According to the Global Entrepreneurship Monitor (GEM) (2012) Ethiopia is the least in entrepreneurial activities in Sub-Saharan Africa. Among its adult population, only 12% were in the process of starting or running businesses. Ethiopia ranked 109 out of 137 countries in terms of financial market development and only 16% of the private sector uses finance from banks for its business activities (World Bank 2020).

Causes for liquidity crisis in the Ethiopian banking sector

The financial sector is very much exposed to internal and external crisis. Understanding factors of financial distress and addressing the problem before it inflicts sever damage to the sector is essential. To determine factors affecting liquidity in commercial banks, a number of thesis and dissertation works, published and unpublished materials, directives and study reports were reviewed and focus group discussions were held.

According to NBE (2022) report, poor cash management practice employed in private banks resulted in severe liquidity challenges, which have led most banks to rely on short-term loans from the central bank via a standing loan facility window. Findings of Selamawit 2023; Wasihun (2020), Abdu (2019); and Rahel (2019) identified loan growth, inflation, low saving and deposits, NBE bond purchase, bank size, capital adequacy ratio, interest rate, reserve requirement, profitability, management efficiency, and non-performing loan (NPL) are major determinants of financial distress in Ethiopia.

1. Investment in DBE/NBE bonds

According to NBE (2022) investments on Government Bonds have reached 10 billion Birr, which is about 30% of the overall deposit of banks in 2022. Forcing banks to spend their deposits on bonds erodes their liquidity base and undermines their position to disburse loans. To solve the liquidity crunch, NBE is expected to relax the reserve requirement and the mandatory rules that force the banks to spend 20% of their resources in purchasing bonds.

2. Inflation

Inflation has a wide range of impact on economic activities of the financial sector (Tadele Anagaw, 2023). The ever-increasing loss of the buying power of Birr; supply chain disruption and internal conflict are main factors that contributed to high inflation rate in Ethiopia. It significantly affected agricultural production, industrial and financial sector performance. The average annual inflation rate in 2021 was 26.8%. In January 2023 it rose to 33.9% and stayed above 30% the whole year (ESS-CPI, 2023). The inflation rate for consumer prices over the past 55 years moved from negative 9.8% to plus 44.4% (WorldData.info 2022).

Inflation results in lower deposits as users need more cash for transaction or depletes by shifting to real assets. The much-decreased number of deposits and savings lead financial institutions to liquidity problem. Contrarily, the high inflationary pressure impacted the repayment ability of borrowers leading to a high loan default rate, both affecting the lending ability of financial institutes.

Monitoring and controlling inflation is essential to lower its impact on investment, economic growth and employment (Assefa et al. 2023). To arrest the inflation rate at 20% between June 2023 and 2024, NBE limited credit growth to a ceiling of 14% and reduced Direct Advances to the Government to 30% of the previous year. In order to discourage banks from overusing the NBE's Emergency Lending Facility, the borrowing interest rate was rose from 13% to 16% in August 2021 and to 18% in August 2023 (NBE press release 11/08/2023). Despite the NBE discouraging measures borrowing from the credit facility increased by 85% (African Business 2023).

3. Increased withdrawal and declining trend in savings and deposits

Banks' liquidity problem: can only improve when saving and deposit amounts increase and cash withdrawal decreases. According to studies made in the banking sector, major determinants of financial distress include significantly decreased deposits and savings because of inflation, instability, and low interest rates (Abdu 2022; Tamene 2020; Assfaw 2019; Tekle 2019). To mitigate inflation risks, people prefer to invest money in properties that can bring profit in the short- or long-run or appreciate through time. This is well reflected in the Ethiopian economy, where citizens lacked interest in saving, but are motivated to buy houses, cars, and jewelry taking loans at high interest rates (18-20%). This might have partly drained the cash from many of the commercial banks.

4. Prevalence of non-performing-loan (NPL)

Though NPL is highly regulated by NBE's prudential and supervisory policies, some banks are in trouble due to high NPL. To some extent, the instability disrupted financial sector operations across the country. For example, commercial banks (CBE, Wegagen, Lion, Dashen and Awash) that have wider presence in Tigray region; and CBE, Oromia International Bank, and Cooperative Bank of Oromia, that were operating in Western Oromia zones witnessed an increase in bad loans as customers are fully unable to repay their loans. Similarly, the economic recession created due to security problems in most investment areas of the country couldn't allow generating income to payback their debts. Generally, commercial banks have a total of 1.6 trillion Birr in outstanding loans until the end of the 2022 fiscal year, which is a 24 per cent increase over the 2021 (Selamawit 2023). Instability, reckless loan approval; mismatch between collateral and the approved loan amount; fund diversion; poor business management; lack of follow-up, technical support and early detecting of risk factors are major contributors for the bad loans which partially contributed to liquidity problem of banks (Adino 2022; Samson 2021).

5. Cash circulating out of the banking system

One of the contributors to banks' liquidity position is the circulation of cash outside the banking system. In between 2019 and 2022, currency outside the banking system was 44.7% while in banks was 12%. The Ethiopian Bankers' Association (EBA) disclosed that there is about 113 billion Birr outside the banking system. Bankers think that such cash flow is normal in situations where the reach of banks is limited and the reserve money is growing at a rate of 15-20% annually because of inflation and growing transactions in line with the growing economic activities. However, economists argue that this is a significant amount to contribute to the liquidity crisis exhibited in the country now (Tadele Anagaw, 2023).

6. Growth in the number of banks

Commercial banks and microfinance institutions in Ethiopia are increasing in number, reaching 31 banks with 10,968 branches and 44 MFIs with 1,074 branches in 2023. Out of 10,968 branches 32.7% of are opened in Addis Ababa (NBE 2022/23). The increase in number of banks and branches created fierce competition among them for the same clients in the same marketplace. This snatch of clients created the spreading of finance over banks and microfinance institutions, which contributed to liquidity deterioration in almost all commercial banks. In such environments, banks are subject to stronger competitive pressures that may cause higher rates of non-performing loans.

To control inflation, addressing macroeconomic factors is more logical to improve banks' liquidity situation in addition to improving loan management efficiency and developing strategies to enhance liquidity positions. Financial institutes should promote savings, while the GoE is securing peace and economic stability and encouraging investment for the financial sector revival.

Effects of liquidity on the performance of the financial sector

Banks create liquidity and are also subject to financial crises due to their role in transforming savings and deposits into loans. Consequently, financial institutes currently face liquidity shortages to disburse loans. They have been compelled to halt approving new loan applications. Subsequently, almost all commercial banks temporarily ceased personal, car, housing, and staff loans even to bankers and hard currency generating NGO employees. Cutting down loan provisions stop or limit running business activities due to shortage of capital; business start-ups will diminish and expansions will be curtailed. Business expansions mostly enhance innovation and improve productivity, fueling the growth of the economy.

Under liquidity crisis, cash demand increases and saving decreases significantly. Lack of enough liquidity could lead to defaults and even bankruptcies in the sector. For example, due to cash withdrawal limitations imposed since 2021, banks control large amounts of transfers and withdrawals from saving and current accounts. The amount started with 100,000 ETB per day before two years and now it has dwindled to 5,000 ETB per day in most banks. Generally, liquidity risk is among the factors affecting the reputation of banks as customers' confidence is being eroded due to the inability to withdraw their deposits when they need it.

Implications on implementing the Guarantee Fund Scheme

In order to relieve the hard collateral requirement of banks and satisfy the financial needs of SMEs and farmers, the Parliament passed proclamation No. 1147/2019 and Directive No. MCR /001/2020. It ordered financial institutions to accept movable assets (livestock, land ownership certificates, warehouse receipts, patents, and intellectual property rights) as collateral. Nevertheless, the implementation of this policy remained unchanged as banks' internal policy was not revised according to the regulation (EBR, 2020).

Though number of banks and microfinance institutions in Ethiopia is increasing and more funds are flowing to the formal financial system, farmers and SMEs' access to finance remained a major challenge regardless of their contribution to the overall economic development of the country. According to Firewoini (2016) private enterprises (SMEs) and farmers are most disadvantaged groups or the missing middles as they lack houses, buildings, and cars, readily accepted as collateral by banks. Currently banks raised their collateral requirements to 234% of the credit value as surety to provide loans. Almost all banks are holding back from loaning as economic and business activities are slowing down and default rates are increasing (EBR 2020).

Loan aversion: A key threat in the banking sector is credit risk. Banks often consider agriculture a risky business and thus, lack the appetite to lend money to SMEs, farmers, and their organizations, which do not have collateral. Banks need to manage credit risks, but should not fear and avoid the largest portion of the population and major contributor to the national economy. Rather, addressing access to finance challenges and extending financial services to the rural community may serve as a gold mine for the banking industry in generating savings, deposits, and interests from diversified loan products.

Experiences on credit guarantee scheme in Ethiopia

Government of Ethiopia (GoVE), NGOs, and development partners have limited experience in guaranteeing loans to the rural poor in collaboration with commercial banks and microfinance institutes (MFIs). Commercial Bank of Ethiopia (CBE); Bank of Abyssinia (BOA), Cooperative Bank of Oromia (CBO); Abay Bank, Anbassa Bank, Enat Bank, and MFIs like the Amhara Credit and Saving Institute (ACSI); Dedebit Credit and Saving Institute (DECSI) and Oromia Credit and Saving SC (OCSSCO) have been providing some loan to SMEs, organized youth and women groups, farmers, cooperatives and unions through third party 100 percent guarantee. Commercial Bank of Ethiopia secures Federal Government guarantee through a letter of intent, which is considered as cash substitute collateral from the Ministry of Finance and Economic Development (MoFED) on the Regional Government's subsidy budget (Bennin 2021; USAID-DCA 2017).

The Food and Agriculture Organization (FAO); USAID Development Credit Authority (DCA); Swedish International Development Cooperation Agency; Netherlands Development Organization (SNV); German Agency for International Cooperation (GIZ); SASAKAWA GLOBAL 2000; Bill and Melinda Gates Foundation; International Fund for Agricultural Development (IFAD), United Nations Industrial Development Organization (UNIDO), the United Nations Capital Development Fund (UNCDF); World Food Programme (WFP); Consultative Group to Assist the Poor (CGAP); World Bank, and International Coffee Organization are some of the development agencies that partnered with financial institutes in availing loan guarantee in Ethiopia by making 100 percent cash deposit in closed account of the partnering bank. The main driver of banks in availing credit to SMEs in such agreement is the quest for foreign currency in working with NGOs and development organizations, which makes it unsustainable. Experiences from the guarantee schemes show that such types of relationships were temporary, fragmented, limited in reach, weak in institutional base and governance; and depended on government or NGOs goodwill. The service stops when the guarantor withdraws from the middle. Moreover, the low amount of fund and; short life span of the scheme coupled with the lack of flexibility and adaptation are some of the notable limitations that hampered sustainability (BENNIN 2021).

Experiences in loan risk management in Northwest Ethiopia

Benefit-SBN experiences from northwest Ethiopia, where a tripartite fund management scheme (NGO-Bank-Farmer organization/SMEs) was employed from 2017 to 2020 indicated that the credit risks could be managed to the level of 100%. For 4 years in a row, 97 to 100% repayment rates were recorded between farmers and their organisations; 100% repayment between farmer organizations and the banks due to need-based release of funds and joint monitoring and evaluation of farm and business activities.

Cognizant of current policy improvements and past experiences in implementing the guarantee fund scheme, Awash, Buna, Siinqee, and Cooperative Bank of Oromia (CBO) were communicated for collaboration. However, these banks lacked interest to give loans to SMEs taking 70% risk. Cooperative Bank of Oromia, which worked with Benefit-SBN at 30:70 percent (SBN: CBO) risk sharing modality requested to reverse the risk amount to 70:30 percent (Project: CBO). The Awash Bank requested for 100% guarantee deposit from RAISE-FS, if not 30% from the project and the remaining 70% equivalent collateral from the groups. Siinqee Bank, a former micro-finance institute in Oromia is unwilling to take the risk. This evidences that banks want to work at zero risk by giving loans selectively to those having 2-3 times higher value collateral. Therefore, the issue of guarantee funds at 30% risk sharing modality couldn't attract banks to collaborate with SWR Ethiopia office. Therefore, the suggestion is either to increase the risk sharing amount from 30% to more than 50% or focus on the revolving fund scheme until the financial situation in the country improves.

Despite the enacted regulation to accept moveable assets as collateral (NBE, 2019), the current bank policy distresses

the majority of the population devoid of hard collateral. Rather it is advisable to develop strategies minimizing credit risks by employing effective policies and procedures; maintaining sound credit-granting standards; monitoring and controlling credit risks; properly evaluating new business opportunities; and identifying and administering problematic credits timely. Considering these challenges, it will be important to (i) test and validate alternative approaches of the guarantee fund scheme, (ii) explore possibilities of a revolving fund approach, and (iii) assess financial policies and regulations posing challenges.

International experience on credit guaranty scheme (CGS)

In developing countries to address the SMEs and farmer organizations' financing challenge, governments and development partners have lent their hands to evolve financial products such as Public Credit Guarantee Scheme (PCGSs), Partial Credit Guarantee Schemes (PCGSs) or Agricultural Credit Guarantee Scheme Fund (ACGSF). A PCGS provides a third-party credit risk guarantee to loan providers through the absorption of a portion of the lender's losses on the loans made to SMEs in case of default. The PCGS has been instituted in more than a hundred countries worldwide and is commonly used to unlock finance for SMEs. PCGS helps curb the effects of cyclical downturns and financial crises on the existing financing gap for SMEs. In times of financial stress, the supply of credit to SMEs is usually reduced due to the weakening of banks' capital and liquidity provision (Bennin 2021).

The CGS and ACGSF were launched by the respective governments to make available collateral-free credit to agriculture, micro, medium, and small enterprises. Ethiopia could take lessons from the Agricultural Credit Guarantee Scheme Fund (ACGSF) of Nigeria; the Private Agriculture Sector Support Program (PASS) in Tanzania; the Agricultural Guarantee Fund (FAG) in Colombia; the National Guarantee Fund for the Agricultural, Forestry, Fisheries and Rural Sectors (FONAGA) in Mexico; USAID Development Credit Authority (DCA) of Ghana, Rwanda, Honduras and Moldova; Agricultural Guarantee Fund Pool (AGFP) of Philippines; and the National Bank for Agriculture and Rural Development (NABARD) of India (Bennin 2021, World Bank 2019). Lessons learned from these credit guarantee schemes for agriculture (ACGS) implemented around the Globe showed the possibility of availing finance to farmers, their organizations, and SMEs. But, needs policy support in positioning CGSs in a broader finance landscape and amending conflicting policies; should have a clear policy to prevent a sudden capital loss in case of catastrophic events; diversify their guarantee portfolios across different commodities, regions, and business activities; select several partner financial institutions that have clear strategic interests in the agriculture sector; and providing technical support to borrowers.

Conclusion and Recommendations

- Improving the accessibility of formal financial institutions and their services such as credit, savings, and payments to rural households is crucial to increase agricultural productivity and contribute largely to rural economic development.
- Despite agriculture's importance in contributing to the gross domestic product, foreign currency earnings, and employment generation, commercial banks consider agriculture a risky business. Thus, their hands are always short to farmers and their organizations. It is paradoxes that in such an agrarian country neglecting the farmer, anchor of the economy. It is also very important to understand that, the main source of money in Ethiopia is agriculture, as directly or indirectly the deposits in financial institutes are generated from the agriculture sector related activities.
- Though SMEs play an important role in contributing to the national economy, they are highly neglected or disfavored by financial institutions. Currently, no financial institution is willing to finance SMEs, unless otherwise fully guaranteed by the Government or NGOs through revolving or youth funds.
- Addressing the access to finance challenges of farmers, women, youth and SMEs requires making fundamental policy changes that enforce financial institutions to assign a certain portion of their portfolio to agriculture and rural financing through guarantee, revolving youth or women funds.
- Availing finance to SMEs, farmers and their organizations sustainably requires setting up organisational structure; strategically innovating, testing, and enhancing new services and products; legally backing agencies that engage in loan collection; building long-term and trustworthy relationships between borrowers and lenders. To this realization making policy decisions at the parliamentary or council of ministers' level is essential.
- The Proclamation No. 1147/2019 and the Directive No. MCR/001/2020 enacted to relax the collateral requirements of banks and accept moveable assets as collateral is not being implemented. It is highly recommended to enforce the regulations in accordance with the law in order to improve financial access to rural areas where hard collaterals are unavailable.
- The RAISE-FS credit guarantee scheme model is a bit different from that of a 100% loan guarantee through a third party where "the guarantor" promises to the loaning bank in case of a default of the borrower. The model proposes banks and microfinance institutes take more than 50% risk as part of their social responsibility and actively participate in financial and business management processes. The project plays more of a facilitation role and provides technical assistance to both parties. Such a relationship will encourage banks to backup; periodically monitor, evaluate, and take necessary measures and manage the financial release mechanism to minimize bankruptcy or misuse of the fund.
- To improve the liquidity challenge and access to finance for SMEs and farmer organizations, it is imperative to take policy measures on inflation and relax the stringent directives on DBE/NBE bond purchase; taking legal actions on cash circulating out of the financial system and the black-market trade of foreign currency, which are disrupting the entire macro-economic situation of the country.

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