

Loan Guarantee Program

Description

Loan guarantee programs are a way to provide business credit to local ventures without actually making and administering the loans. That is, instead of directly lending the dollars, a CEDO will recommend that a loan be made by a conventional lending institution, a bank or a credit union, and remove the risk of the loan by guaranteeing its repayment. The guarantee is secured by a deposit by the CEDO at the lending institution. This technique is used primarily for short-term to mid-term loans of a relatively modest size for individuals or for peer groups. For the rural or regional setting, the individual loan format is more practical than the group peer lending format (see [Microenterprise Loan Fund](#)), simply because of the distances separating the borrowers.

The CEDO does all of the preliminary work in qualifying the borrower and his/her venture, using whatever screening and application procedures are deemed appropriate by the CEDO. Such procedures tend to vary greatly from one loan program to another. In some instances, there may be no formal application, other than submission of a short business plan. In some circumstances, the program may include considerable preliminary consultation with program staff or consultants; in others, there may be none at all, until the ultimate qualifying interview with the CEDO's loan committee.

Once the borrowers have been approved, they will be directed to the bank, credit union, or other lender with which the CEDO is working, to get the loan and to make the arrangements for repayment to the institution on the schedule approved by the CEDO. In short, the lender acts as an agent of the CEDO, but does not do the work of analyzing the loan to determine whether it should be made or establish the loan conditions, terms, and amounts.

It is the risk-reduction preliminaries (screening procedures) that are the most costly part of making loans, and the CEDO absorbs those costs and further reduces the lender's risk by the guarantee. These are key to providing loans that would not otherwise be made. The lender receives payments of interest on the loan to offset all or some of its own administrative costs.

The actual terms of the arrangement between the CEDO and the lender can vary considerably. For example, they may share in different percentages the interest paid by the borrower. Or the standard guarantee may be only partial, say, 80 percent of the total loan, so that the lender accepts 20 percent of the risk. And there may be other varying terms in the contract between CEDO and lender, for example, having to do with the size of the deposit that must be made by the CEDO and the interest, if any, that the lender must pay on it. In

many instances, lenders will offer concessionary terms to a CEDO, simply as their contribution to a CED effort in what is, after all, their community too.

The six different guarantee programs established by WRED (Women and Rural Economic Development) in its target region of rural and small town Western Ontario illustrate the variety of arrangements that can be made. Two of the programs are with credit unions and the rest are with three Community Futures Business Development Companies. All arrangements depend upon a 100 percent guarantee, but the lenders may accept collateral from the individual borrower and thus reduce the needed guarantee. WRED got most of its initial guarantee dollars from a faith-based coalition. (See [Program-Related Investment](#).) The program has had about a three percent loss ratio, with total loans around \$100,000.

Benefits

The prime benefit of this technique is that the CEDO can get loans to reliable people who would not otherwise get them. And sometimes it can get out more in loan dollars than it would be able to on the basis of the actual amount of loan capital it has on hand. That is, by arrangement with the lender, the CEDO's dollar deposit at the lender may be somewhat less than the total amount being lent out at any one moment under the program. The reasoning on this is, of course, that even though a few loans may turn out to be bad, the call on the guarantee deposit would be fairly low. For example, most loan guarantee programs turn out to have a loss ratio not much more (and sometimes less) than the lender's own usual losses on business loans. And the dollar leverage of the CEDO's capital may be increased even more if the co-operating lender does not require a 100 percent guarantee on its loans for the CEDO.

Additionally, the CEDO is relieved of the bookkeeping and other responsibilities of administering the loan, generally including the usual procedures for following up on late payments or non-payments. It can instead allocate its time to helping its borrowers avoid such lapses and to qualifying new potential borrowers.

Major challenges

The major challenge to the CEDO stems from the nature of most would-be borrowers targeted by this strategy. Namely, they are often not fully prepared to do the best job in their own businesses. That is, they usually need a lot of technical assistance (and perhaps even formal training) in setting up or re-shaping their venture so that it will be creditworthy, even under the friendly terms offered by the CEDO. Just to make out an application form may be a struggle for the would-be borrower. So somehow the CEDO has to manage the extra services required for qualifying the entrepreneurs. These are expensive of time and specialized attention. It is quite possible to help a significant number of businesses into viability, but it is

costly. Of course, to the extent that the CEDO is unable to allocate resources for this task, it limits the potential new ventures in its community.

Some practical steps

1. Naturally, the first task is to garner the dollars that will be placed on deposit for the guarantee purposes. The size of the fund will depend upon the projected demand. Perhaps a minimum of \$15,000 would be a reasonable target figure until a greater demand is discovered.
2. Concurrently with raising the fund, the CEDO should be establishing its guidelines and procedures for qualifying borrowers.
3. With the fund and procedures in hand, a lender can be formally approached to negotiate a relationship. Actually, the CEDO may have already had preliminary talks with potential lenders to sound out possibilities.
4. Once an agreement is reached with a lender, the program can begin accepting applications for loans. Whether or not the program actively seeks borrowers or merely depends upon referrals, e.g., from the lender, will depend upon its capacity and the demand otherwise for these loans.

Resource organizations & contacts

While there is a trade association of those concerned with microenterprise loans (the usual type associated with the guarantee programs), probably the best source of advice will be those groups in Canada that have successfully launched a guarantee program:

- WRED (contact Julie Birch at 519-273-5017).
- The Calmeadow Foundation is known as an innovator in this field (telephone: 416-362-9670).

Publications

Rural Enterprise Loan Fund Guidelines, produced by WRED, (519-273-5017) is focussed on the guarantee arrangement but can be used more broadly for direct loan fund programs.