يونيكونز للاستشارات المحدودة

Study commissioned by the Central Bank of Sudan (BOS)

COLLATERALIZATION & GUARANTEES IN THE EXPANSION OF MICROFINANCE IN SUDAN

Final Document

November 2007

Central Bank of Sudan
Gamhoreya Street, Mogran, P.O. Box 313Khartoum,Sudan
Tel.(+249-1) 83774420 / (+249 -1) 87 506319
Fax: (+249 -1) 83 780276
Tel. (+249 -1) 83 590631/2 Fax: (+249 -1) 83590629
www.sudanbank.org

UNICONS Consultancy Ltd.
Street 21,Bldg.74D/H, New Extenstion (Amarat)
P.O. Box:8149, Khartoum, Sudan
Tel. (+249 -1) 83590631/2 Fax: (+249 -1) 83590629
www.unicons.org
info@unicons.org

UNICONS CONSULTANCY TEAM

Mustafa Abukasawi
Ahmed Abdelsalaam
AbdelmajidKhojali
Magdy Moussa

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ABBREVIATIONS:

ABS	Agricultural Bank of Sudan
ACCION	Americans for Community Co-operation in Other Nations
ACORD	Agency for Cooperation in Research and Development
ADRA	Adventist Development and Relief Agency
BOS	Central Bank of Sudan
BUD	BRI-Unit Desa
CBO	Community Based Organization
CGC	Credit Guarantee Company
CGS	Credit Guarantee Scheme
CDC	Community Development Committee (NGO)
CSO	Civil Society Organization
DICGC	Deposit Insurance and Credit Guarantee Corporation
DUGAP	Dutch Universities Gedarif Assistance Program
FAR	Fellows of African Relief (INGO)
GEF	Global Environment Facility
GEP	Graduates Employment Project
GOI	Government of Indonesia
GOS	Government of Sudan
GTZ	Deutsche Gesellschaft für Technische Zusammenarbeit GmbH (German society for technical cooperation)
GWDA	Gedarif Women Development Association
ICDB	Islamic Cooperative Development Bank
IDBI	Industrial Development Bank of India
IDP	Internally-Displaced Person
IFC	International Finance Corporation
ILO	International Labor Organization
INGO	International NGO
IPTW	Incentive to Pay on Time
IRC	International Rescue Committee (INGO)
L-NGO	Local NGO
MA'AN	Means "together", a network of nine CSOs, mostly women, Gedarif
M&E	Monitoring and Evaluation
Mfin	Microfinance
MFI	Microfinance Institution
MFP	Microfinance Portfolio
MON	Microfinance Organizations Network
MOSCA	Ministry of Social and Cultural Affairs
NBD	National Bank for Development
NFSI	National Fund for Social Insurance
NGO	Non-Governmental Organization
NIDB Group	Nilein Industrial Development Bank Group
NKRDP	North Kordofan Rural Development Project
NPF	National Pensioners' Fund
OXFAM	Oxford Committee for Famine Relief
PASED	Port-Sudan Association for Small Enterprises Development
PAR	Portfolio at Risk
PC	Popular Committee
PTPG	Personal Third Party Guarantee
RF	Revolving Funds

Pajaj	A three-wheel motorcycle used in local transport
Sandug	A revolving fund managed by a village committee
SEWA	Self Employed Women Association
SDG	Sudanese Pound (present legal tender, One US $ = SDG 2)
SDA	Sudanese Development Association
SDF	Social Development Foundation
SFD	Social Fund for Development
SHG	Self Help Group
SME	Small and Medium Enterprise
SSDB	Savings and Social Development Bank
TOT	Training of Trainers
UNCHS	United Nations Center for Human Settlement (UN Habitat)
UNDP	United Nations Development Program
UN-Habitat	United Nations Centre for Human Settlements
UPAP	Urban Upgrading and Poverty Alleviation Project
USAID	United States Agency for International Development
WDA	Women Development Association
WOTAP	Women Training and Promotion Society

PREFACE

One of the major obstacles that have been identified as impeding the growth of the microfinance sector in Sudan is the stringent demand for sufficient guarantees and securities to cover the risks that can ensue in any business deal. Banking sector laws and Central Bank (BOS) regulations and polices require banks to have adequate and easily liquidated guarantees as a major condition for the provision of credit. However, it is well known that small and micro borrowers/entrepreneurs, in general, and women within this category, in particular, have particular difficulty in presenting the needed guarantees simply because they do not possess them.

The experience in Sudan has also shown that another reason for the reluctance of lenders (whether, the banking sector or other financing institutions) to provide loans to micro borrowers is because of difficulty of recourse in time of default and this is again due to the absence of adequate guarantees. Recourse is not only excessively slow but also costly contributing to making microfinance unattractive to lenders.

In recognition of the constraining capacity due to collateralization or lack thereof, the Central Bank of Sudan (BOS) commissioned a study on “Collateralization and Guarantees in the Expansion of Microfinance Services in Sudan”. This was assigned to Unicons Consultancy in July, 2007. The Objective being to define and make recommendations on attributes for successful utilization of alternative collaterals and guarantee systems – at end-user level, as well as at the institutional (MFI) level - needed to stimulate greater provision of microfinance services by MFIs – both banks and non-banks. Greater flexibility in defining the type of collateral that constitutes an acceptable securitization in the provision of microfinance will necessarily entail recourse to unconventional collateral mechanisms as a means to stimulating MFIs, and particularly banks, to expand in their provision of such financial services.

The methodology of the study was set to conduct a market survey in three different states in the Sudan representing different practices in the use of collaterals that vary in accordance with geographical location as well as different social attributes. Based on the findings of the survey - in terms of current practice in collateralization in both the formal as well as informal sectors in Sudan - the study considers the legal, policy and regulatory framework for collaterals and guarantees needed to expand access to microfinance services. Local consultants in partnership with regional expertise formed a strong team to undertake the work. In line with the firm’s policy, the study assimilates international best practice in its recommendations by carefully considering their adaptability to the Sudanese case.

Accordingly, the study first considers, in chapter one, the international experience in collateralization and guarantees before detailing, in chapter two, the experience of Sudan as evidenced from the findings of the field survey. A brief exposition of legal perspectives of such collaterals and guarantees follows in chapter three. The final chapter is allocated to the conclusions and main recommendations emanating from the study. This forms the crux of the study with the recommendations being summarized in the form of an action plan with specific time frames for implementation.

Abda Y. El-Mahdi

CHAPTER 1

COLLATERIZATION & GUARANTEES: THE INTERNATIONAL EXPERIENCE[1]

A. COLLATERALS – CONVENTIONAL/ NON CONVENTIONAL

The challenge of the microfinance industry had been and will always be to outreach to more clients whom –by default- do not have the ability to provide traditional loan collaterals, and do not have easy access to credit guarantee services. Collaterals or rather the lack of them has been found to represent a major constraint to accessing loans by small and micro-entrepreneurs and especially new entrants to the financial market. It is also a constraint to the banking sector as it precludes the provision of financing to a large sector of the economy which might be most viable and profitable. Such lack of collateral leads to sub-optimal flow of formal credit to a large section of the population as represented by the economically active poor and small and micro-enterprise sector. This in itself represents a concern to public authorities who are responsible for supervising and developing the financial sector. It is also an issue in the fight against poverty and efforts at providing sustainable livelihoods to the poor.

This attention has given rise to a lot of trials regarding formal and informal types of collaterals to be asked from borrowers by lenders and MFIs in general. The types of collaterals differ according to many factors, including but not limited to: targeted group, amount and tenor of loan, MFI legal type, community tradition and practices, social fabric, property registration procedures - costs and time, court processing time, effectiveness of law enforcement, among others. This means that the choice of a specific collateralization mechanism depends to a large extent on factors that are not directly related to industry best practices and is tightly linked to financial and legal environments.

The issue of legal and financial environment would gain a specific importance when we test applicability of collaterals in an Islamic based financial market. We will outline an application of collateral in the environment of Islamic financial markets.

A.I. Conventional Collaterals[2]

According to the ILO's definition, collateral is *"an asset pledged to a lender, until the borrower pays back the debt. In case of default the lender has the right to seize the collateral and sell it. Collateral serves to protect the lender against risk; it screens potential borrowers and is an incentive to respect the repayment obligation"*. Depending on the nature of the assets, the extent of physical possession and the relation with the underlying debt claim, we can broadly distinguish four categories of collaterals, these are: personal guarantees, assignment for security, pledging/pawning, chattel mortgage[3].

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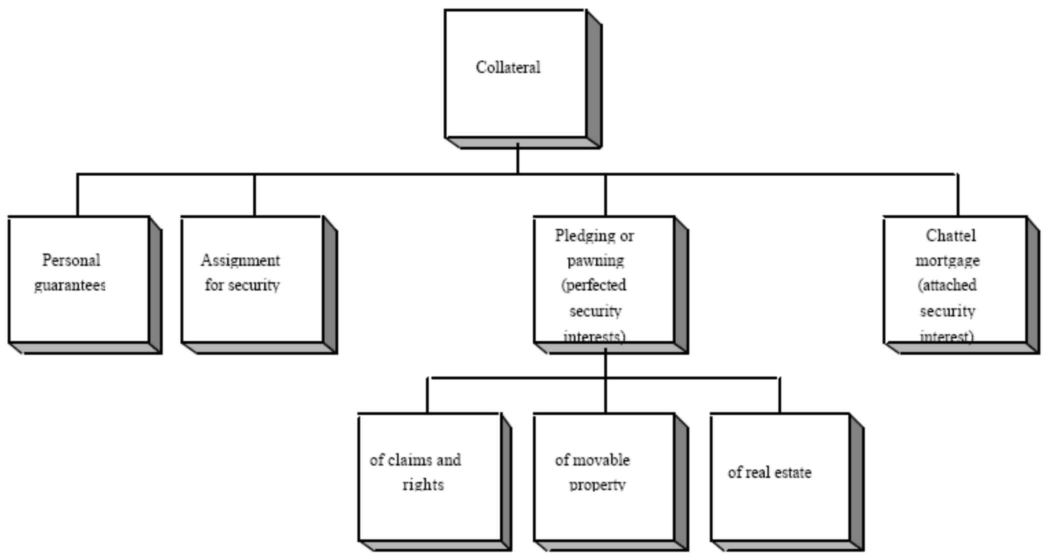
[1] This chapter is taken from the Unicons prepared literature review which is part of the study commissioned by the Central Bank of Sudan on "Alternative collaterals", August, 2007.

[2] This section refers to an ILO's study: *Securing small loans: The Transaction Costs of Taking Collateral*, Final Report, February 2001, which compares collateralization practices of micro finance institutions in three countries (Bolivia, Tanzania, and India)

[3] B. Balkenhol, H. Schütte. "Collateral, Collateral Law and Collateral Substitutes." Social Finance Programme, International Labour Office Geneva, Working Paper No. 26, 2nd edition. http://www.ilo.org/public/english/employment/ent/papers/collat.htm

Conventional collateral instruments



A.I.1. Personal guarantee

Third-party personal guarantee (TPPG) is a commonly used collateral where a third party takes responsibility to ensure the repayment of the loan and interest in the event that the borrower fails to repay. In some cases, bank MFIs request a salary transfer of the guarantor throughout the life of the loan. Moreover, some MFIs prefer co-obligation to third party-guarantee as this allows the lender to have parallel and simultaneous recourse to the co-obligant without having to exhaust their recourse against the borrower. This is considered a major collateral point of strength from the lender's point of view, especially in case of actual salary transfer of the guarantor. The major disadvantage is that personal guarantees are normally accepted from regularly salaried employees or solvent merchants, both may not be available, and if available not in sufficient numbers in grass root neighbourhoods, therefore limiting service outreach.

A.I.2. Mortgage of fixed assets

Land is a traditional form of saving and/or investment and the most commonly available security and most convenient collateral for small farmers in agricultural economies. Charges on land, buildings or other real property is the most important collateral instrument for small loans in many countries and numerous financial institutions make use of it. The borrower submits ownership documents to the lender as security for a loan which guarantees that the borrower is not going to sell their property until repayment is complete.

Banks usually prefer mortgages on land and buildings, despite the many problems that limit the usefulness of real securities. As securing a loan with a mortgage usually requires a minimum loan amount, this collateral is usually not chosen to secure very small loans. However, the heart of microfinance is to serve the "un-bankable" including many potential clients who may have the land and have been cultivating it for a long period of time, yet do not have a land deed. The issue of registration of land is viewed as a major obstacle for many farmers who do not have a deed covering their possession. This challenge relates directly to the legal environment and registration procedures, an area where the government can play a major role.

The information obtained from banks and MFIs indicates that in all three countries surveyed by the ILO (Bolivia, Tanzania and India) fixed asset mortgage and personal guarantee are the preferred security instruments in small-scale financial transactions.

A.I.3 Chattel mortgage

Chattel mortgage is when the lender has a mortgage of a movable asset (certain homestead items and other clearly defined items which are necessary to carry out production) but the asset is left in the custody of the borrower. The advantage for the borrower is that s/he will continue to possess and utilize the asset, regardless of it being mortgaged. On the other hand, the disadvantage for the lender is that even when the mortgaged object can be registered, the difficulty of legal removal or sale and lengthy judicial processes make this collateral problematic for banks and hence this type of collateral is usually combined with personal guarantee.

A.II. Collateral Substitutes

The notion of Collateral Substitutes was created to overcome the hindrances put forward by conventional forms of collateral; they replace conventional assets by objects without a significant market value and exclude judicial proceedings[4]. Therefore, in contrast to the conventional, legally recognized forms of collateral, collateral substitutes do not have a market value and claims cannot be enforced through courts. Instead of making use of legally enforceable claims, collateral substitutes secure a loan by ways of moral, social or other pressure.

In practice, the distinction between common forms of collateral and collateral substitutes has become blurred: for example, durable consumer goods (kitchen ware, electric appliances) pledged to the lender have a market value, too. Micro-finance institutions in different parts of the world have adopted collateral substitutes or a combination of conventional and unconventional forms of collateral. Surveys have also revealed a shift from collateral substitutes to conventional collateral, whenever a client "graduates" to higher loan brackets.

Enforceability of loan contracts and marketability of seized assets signal the borderline of the formal financial sector; if a major objective in financial sector development is to broaden the access of the poor to the market, then it is interesting to explore ways to enforce lender claims that do not involve courtrooms. In most developing countries, the law and its administration do not reach the poor; and even if they did, then the poor would not be able to afford costs of legal recourse. Hence, adopting an extra-legal mechanism would certainly broaden access of the poor to the market.

The same applies to marketability; while the poor have no or very limited tangible assets that can be pledged as collateral, they usually do have some personal or family belongings to which they are attached; if such "assets" perform comparable risk protection and screening functions and are accepted by a bank, then this could also contribute to financial sector broadening[5].

Some of the most common examples of collateral substitutes are the following:

A.II.1. Peer Pressure:

Peer pressure is an innovative and unconventional form of collateral applied on a large scale by the Grameen Bank in Bangladesh, where loans are given to group members individually yet all group members are jointly responsible for repayment. To qualify, Grameen's customers have to be extremely

[4] Ibid.

[5] Ibid.

poor, probably earning less than a dollar a day. To overcome the lack of collateral or data about creditworthiness, group members were required to monitor each other at weekly meetings and pressuring one another to ensure repayment. As loans were repaid, people are allowed to borrow more and the group replaced the security that pawnshops gained from collateral.

This approach has been tried in many areas over the world and has proven success, even though it may not have a judicial enforcement aspect. In communities with tribal nature and strong social fabric, this technique could be safely practiced. It is low cost technique, but on the other hand, it requires a stringent internal control environment and very close coordination for the group dynamics, thereby incurring significant operational costs on the MFIs' side.

Intensive follow-up and supervision have prevented commercial banks from adopting group collateral unlike MFIs. The Tanzanian survey found that only one of a total of eighteen banks interviewed accepted group collateral. However, it is worth noting that MFIs in Tanzania have made extensive use of group collateral with a recovery rate well above 95 percent[6].

Peer Pressure and other forms "Social Collateral" aid the poor in breaking out of the poverty cycle by giving them access to credit and allowing them an opportunity in the market which in turn promotes business investment and leads to increased savings and eventually financial independence. CGAP analysis shows that 'social collateral' can be created in certain situations but that group loans will be offered by lenders and chosen by borrowers ahead of other forms of finance only where group members have a very substantial monitoring and enforcement advantage relative to outside monitoring intermediaries and where the correlation in project returns across borrowers is not too large.

A.II.2 Pledging of household goods and personal belongings- Pawning

The pledging of gold ornaments and jewellery are popular forms of unconventional collateral substitutes in certain regions where poor people prefer to keep their savings in the form of gold or jewellery. Banks tend to accept this form of collateral due to its relatively low costs as costs of loan monitoring and supervision are decreased[7]. In addition, gold ornaments and jewellery are easily marketable; in case of default banks are free to resort to public auction of the pledged ornament. Three factors influence the bank's decision to accept such a security: the honesty of the person who appraises the pledged ornament, safe custody of the items, and the volatility of the price of gold or jewels[8].

A.II.3 Documents in custody:

Documents showing the ownership of an asset are kept in the bank's safe until the borrower repays the loan[9]. Hence, the borrower cannot sell the respective assets. However, the bank cannot legally claim the assets either. The power of this collateral on the borrower is only a moral one.

A.II.4. Post-dated Checks (Alternatively Promissory Notes):

Where borrowers sign a number of post-dated checks or promissory notes corresponding to each instalment. In some MFIs, clients are also required to sign on an undated check with the total amount of loan. This type of collateral has its own benefits and limitations. On the benefit side, it is very low cost collateral on the lenders and borrowers' side. It is very powerful in the hands of the lender since the borrower could be imprisoned for default. On the other hand, it is viewed as a destructive tool for

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[6] Ibid.
[7] B. Balkenhol, H. Schütte. "Collateral, Collateral Law and Collateral Substitutes." Social Finance Programme, International Labour Office Geneva, Working Paper No. 26, 2nd edition. http://www.ilo.org/public/english/employment/ent/papers/collat.htm
[8] Ibid.
[9] Ibid.

creating entrepreneurial spirit among targeted clients as their major incentive to comply may be the fear of imprisonment rather than fulfilling their obligations. Some legal expert's view that signing post-dated checks for micro loans is unethical.

<u>A.II.5. Linking Credit to Savings</u>:

A number of Banks and MFIs require prior deposits before making a loan; whether a savings deposit/account or a current account, etc. Depositors are granted priority by the banks while considering loan proposals since banks consider the ability to save a positive characteristic in a borrower and also a form of security. In other MFIs, only members with a solid track record of repayment and good savings history become eligible for a loan.

The main reason given for the prior saving requirement is that it helps to "inculcate the habit of saving and impose financial discipline" among their target populations[10]. While the intention is good, it is not clear whether this is the best way to go about it especially that such savings are essentially 'blocked accounts' and hence borrowers are not able to access their savings. This becomes a disadvantage especially in cases where the compulsory savings reach significant percentage of the loan amount. To overcome this, emphasis is given to provision of savings services on terms that promote voluntary savings. Living evidence that voluntary savings are a needed service by poor people as well as an efficient collateral is given by the example of Bank Rakyat Indonesia *(*BRI) in the box below.

A.III . Loan Collateralization in Islamic Microfinance

The disbursement of uncollateralized loans in some cases constitutes an example of how Islamic banking and microfinance share common aims. Thus Islamic banking and microcredit programs may complement one another in both ideological and practical terms[11].

Islamic principles of equal opportunity, advocacy of entrepreneurship, risk sharing, disbursement of uncollateralized loans, and involvement of the poor are consistent with microfinance principles. Islamic finance has an important role to play in widening provision of funds to enable the purchase of, or building of, homes, and in enabling their owners to use the property for further income generation. Given the fact that both mudharabah and musharakah are equity financing in character, collateral is not a prerequisite. Correspondingly, MFIs' innovative group-based format introduces social collateral minimizing the asymmetric information problems and ensuring higher recovery rates. Most MFIs worldwide, however, are non-Islamic in character.

<u>A.III.1. Al-Rahn meaning Collateral</u>

Al-rahn means a pledge or a security related to a loan; according to Shariah, al-rahn is by definition, possessing a guarantee[12]. The Quran refers to the idea of mortgage as 'mortgage with possession' (rihanun maqbudha) and hence mortgage was common in Islam; Quran also supports the idea of furnishing a pledge against a debt.

According to Islamic law, pledge is a security for the repayment of debt in case the borrower failed to repay it; it is a contract of pledging a security that becomes binding when possession of the pledge has

[10] Abstract about MFIs in Ethiopia: *Issues of portfolio risk, institutional arrangements and governance*, by Gebrehiwot Ageba

[11] Segrado, Chiara. Case study "Islamic microfinance and socially responsible investments", MEDA Project, 2005

[12] Nizar, Shariq and Javed Ahmed Khan. "Collateral (Al-Rahn) as Practiced by Muslim Funds of North India". <u>Islamic Econ.</u> Vol. 17, No. 1, pp17-34. 2004 http://www.cba.edu.kw/elsakka/171-Javed_07.pdf

taken place. Ownership of the security is not automatically transferred to the lender; it occurs only under certain conditions. Al-rahn also refers to an arrangement whereby a valuable asset is placed as collateral for a debt. The collateral may be disposed off in the event of default. Al-rahn is the agreement to deliver the customer's asset for a collateral to the bank. When the asset is gold, silver, certificate of deposits, bonds, cheques etc. it will be physically possessed by the bank, but for vehicles and houses (property) the customers are only required to give ownership certificates.

A.III.2 Muslim Funds and the issue of collateral

The Islamic system of banking and finance, in its essence, is believed to contribute to the emergence of a just and growing healthy economy by giving small enterprises the opportunity to obtain finance on participatory basis in which a collateral would not be necessary.

Muslim economists argue that since the Islamic system is a system based on participatory financing then Islamic banking would not depend on tangible collateral as much as Interest based/Western banking. Western/Interest based banking system generally provides credit to those clients who are able to offer sufficient tangible collateral that gives them legal entitlement to tangible assets in the event of default.

However, in the long run this banking policy further widens the already large income gap between the upper and lower classes of the society. Furthermore, the existence of collateral requirements makes banks indifferent to the efficiency or success of the business being financed by the loan, as many inefficient micro-businesses may secure credit by the virtue of collateral. Conversely, many efficient micro-businesses/ micro-entrepreneurs may not find access to credit because they are not able to provide sufficient collateral.

Once collateral requirements are removed, it becomes crucial for banks to screen projects on the basis of their feasibility; if a project is unsuccessful then it will not be able to make repayments to the bank hence the bank is bound to screen projects vigilantly. There has been a debate among the Muslim economists and the *ulama* on whether collateral is required for Islamic financing activities; Muslim economists have given theoretical justifications that as the profit and loss sharing arrangements, like the equity financing, implies risk sharing, it also by-passes the collateral requirements because in their views, this would improve the efficacy of the credit market.

In India, Muslim Funds, registered under the Charitable Trust Act of the Government of India, are not entitled by rule to invest depositors ' money. Furthermore, these Muslim Funds do not practice any of the Islamic principles of financing such as *mudaraba*, *musharaka* or *murabaha*[13]. The study has shown that as inferred by the aforestated information, Muslim Funds in India are heavily dependent on the collateral for their existence. Since they operate under the rules of the Charitable Trust Act rather than the banking laws of India, they are required to collect collateral or any type of special security.

[13] Nizar, Shariq and Javed Ahmed Khan. "Collateral (Al-Rahn) as Practiced by Muslim Funds of North India". Islamic Econ. Vol. 17, No. 1, pp17-34. 2004 http://www.cba.edu.kw/elsakka/171-Javed_07.pdf

BOX (1) The Transformation of a Rural, Micro-finance Institution in Indonesia:*

The Indonesian experience in transforming its directed and heavily subsidized agricultural credit program into a the self sustaining and profitable one known as (BUD), provides many lessons in broadening financial market access to the poor. The transformation started when Indonesian authorities realized that they could not afford to continue supporting the debilitated agricultural credit bank especially with the falling oil revenues and deteriorating loans collection. Hence, the Government of Indonesia instructed the BRI (the state owned bank that hosted BIMAS) to either change drastically the "rules of the game" or to shut down all operations and a pilot subsidy of about $70 million was given to test different modes of operation to achieve later self-sustainability.

As a result, BUD introduced profound structural changes aimed at achieving self-sustainability within two years BUD and succeeded in achieving full coverage of its costs within that period. Since then it has generated profits that are unprecedented in rural finance operations, yielding return on assets of 6 percent and more.

The key features of BUD that explain its success in shifting the paradigm from traditional agricultural credit to rural financial intermediary are diverse and complementary to one another. But one very important aspect is that BUD does not solely rely on traditional collateral to ensure repayment; it promotes voluntary savings and is flexible with accepting any pledged assets as collateral. For example, BUD would take a pledge of anything the borrower owned such as chairs, beds, etc.; the documentation of collateral for each loan was more to exercise moral pressure on borrowers and establish their serious intent to repay rather than provide basis for legal action.

BUD does not have an obligatory saving requirement due to the negative effects of forced savings that cloud both the cost of credit to the borrower and the actual net credit outstanding, BUD regards this practice as a particularly inefficient form of financial intermediation. BUD has built its success on mobilizing voluntary savings from people who want to save excess funds and in turn lends that money to creditworthy borrowers.

Incentives were essential to break the vicious cycle of default; there was an "Incentive to Pay on Time" (IPTW) scheme . Also, incentives such as bonuses for every profit that the unit makes were made to employees in order to ensure a better screening of borrowers and high loan repayment. As a result loan recovery improved dramatically while loan disbursements greatly increased as many clients have made use of their eligibility for larger loans arising from their timely loan repayments. Moreover, saving became extremely popular and soon exceeded the outstanding loan portfolio. As a result BUD became financially independent,

The success of BUD could also be attributed to the fact that it was operating as a separate profit centre within a large bank and hence could benefit from economics of scale and scope including daily clearance of surplus liquidity carried out by BUD. Presently BUD serves more than 20 million depositors and about 2 million borrowers with a variety of financial services generating a substantial impact on rural development, yet with no need for any support from the GOI, local governments or donors. It was important for BUD to rely heavily on rural saving and to price such saving appropriately. This allowed BUD to build long lasting lending relationships with low income, collateral lacking borrowers and efficiently serve them while fully covering the related cost involved.

* Yaron, Jacob. "Rural Microfinance: The Challenge and Best Practices". Tanzania, March 2004. < http://www.bot-tz.org/MFI/Library/RularMFI_BestPractices.pdf.

B. CREDIT GUARANTEE SCHEMES

A credit guarantee is a financial instrument that encourages financial institutions and, in particular, commercial driven institutions to lend to micro enterprises that have good prospects of success but are unable to provide sufficient collateral or do not have a suitable record of financial transactions to prove their creditworthiness[14].

Although the objectives, features and types of different Credit Guarantee Schemes (CGS) vary, their *raison d'être* remains the same: *"guarantee schemes are programs that insure the repayment of a loan, in part or in full, in order to motivate lenders to lend to groups which would not have access to credit under normal circumstances"*. There are several reasons why these groups are generally turned down by banks. Some of the reasons for this behavior are:

• The client does not have a financial record.
• The client belongs to a group considered as "risky" by the banks.

These groups comprise small farmers, small and medium enterprises (SME), women and the poor, among others. There is an ongoing debate about the effectiveness of CGS in developing financial systems. While some argue that developing institutions specialized in micro lending is a more efficient way to reach the target groups, others consider that the benefits associated with the CGS surpasses the costs, to the extent of being a lucrative market for insurance companies and specialized funds.

B.I. Key criteria for Effective Guarantee Schemes [15]:

There are some general conditions that must be in place to create an enabling environment for guarantee funds to function effectively. First, the banking system must be sufficiently liquid so that they can use their financial resources to lend to a new sector. Second, participating banks must have a healthy financial portfolio and adhere to regulations that prove that they are solvent and responsible financial institutions. Third, there should be a commitment within the institution's board to offer services to the targeted sector. Banks will tend to use a guarantee only when they are committed to reaching new clients, which could be for a variety of reasons. For a guarantee scheme to succeed, banks must see these borrowers as potentially profitable and need to make an institutional commitment to develop them and their businesses.

Critical design features for guarantee schemes include the following:

- Loan and guarantee approval process: The due diligence process associated with information gathering, analysis, and monitoring needs to be structured to minimize duplication and costs.
- Costs and fees: Many guarantees are successful in the promotion of use by banks, but less successful in their attempt to lend to the targeted borrowers. It is more effective and less costly for guarantee schemes to use a key set of criteria to target borrowers and approve guarantees rather than to evaluate each individual borrower.
- Risk sharing: Risk should be shared among participants so as to minimize the overall required risk premium. There should be an attempt to distribute the risk premium pro rata by the entities that are assuming risk.

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[14] Environmental Quality International (EQI). "Research study of Credit and Credit Guarantee Schemes". The Ministry of Finance (Egypt). Nov 2004
http://www.sme.gov.eg/English_publications/Credit_Executive_Summary.pdf

[15] *Public and Private Investments in Microfinance: A Look at Guarantee Instruments* (Technical Note no. 7, 2000)

- Credibility of the guarantee: Careful attention should be placed on the fund's capitalization and value maintenance through fees or interest earned, to ensure the guarantee entity's solvency.
- **Guarantees should be temporary:** A time frame should be established for commercial banks and MFIs to bridge existing information and cultural gaps. The guarantee should strive to bring the lender and borrower closer together, allowing the MFI to upgrade its capacities and establish a working relationship through successful repayment, thereby bridging the gap over time and making graduation possible.[16]

With every loan, banks assume risk and transaction costs. Guarantee funds need to be designed to encourage banks to lend beyond their normal practices or comfort zones. Successful guarantee instruments need to push the comfort zones of banks so that high-risk borrowers become bankable borrowers. As a result, they must address the issues of information, risk, price, and management of the fund.

B.II. Guarantee schemes applicability in Islamic based financial markets

It is clear that the main purpose of a credit guarantee is to offset credit risk for a lender. This fact should be carefully considered when attempting to test guarantee schemes' application in an Islamic based financial market. Apart from Murabaha "sales on profit", Islamic modes of finance have a common premise; that is to share the risk and accordingly the rewards between the financier and the borrower. This is especially true for the two other main types of finance "Musharaka" and "Mudaraba"; where they depend on a financing arrangement with the borrower to work with the money "capital injected" for a period of time and then share the profits/loss with the financier at a given point in time and on a pre-agreed upon basis.

This however, does not mean that credit guarantee schemes are simply inappropriate tool in Islamic based financial markets. If we look at the roots that cause micro entrepreneurs to default, we will find that they are largely related to personal, family, or business crisis causing them to default on their payments. Therefore, hedging clients against disability, critical health conditions and natural disasters affecting their businesses and houses could be accepted from a "relief" stand point for the sake of the borrower. In that case, the schemes may benefit the borrower for medical treatment or for off-setting the effect of the crisis, and may also benefit the financier[17] in recovering part of the original capital invested in the transaction. This could be viewed as a type of "takaful" or even assisting the defaulter being in debt and unable to pay "al-gharemeen" which is a legitimate Islamic category for charity.

In summary, an Islamic based microfinance market would probably reject guarantee schemes that concentrate solely on hedging the credit risks of the lender; this is especially true for Musharaka and Mudaraba agreements. Therefore, endorsement of religious authorities should primarily be secured during the early design stages (sketching) of any guarantee scheme; even before testing its financial and operational viability.

B.III. The Perceived Role of Governments in Credit Guarantee Schemes

The performance of government financed schemes has significantly varied. In Europe, North America, Japan and the rest of the developed world, the performance of these schemes in terms of sustainability, credibility, loss rate, and additionality has been good compared to the developing countries especially

[16] Navajas, Alvaro Ruiz. "Credit Guarantee Schemes: Conceptual Frame", GTZ: Financial System Development Project. Nov 2001. http://www.fondesif.gov.bo/CGS-Conceptual%20Frame.pdf
[17] After obtaining proper religious authorities endorsement

African, Middle East and some Asian countries. The main reasons for low performance of government financed and managed CGFs in these countries can be attributed to management problems associated with the design of the scheme, delays in applications submitted for guarantees, delays and disputes in settlement of claims, high loss rates and limited funding. The table below reflects some information on the constraints and failures of GCGS in some African countries. Due to these operational constraints, most of these funds have ceased to operate.

Constraints and failures of government credit guarantee schemes in some African countries

Cameroon	Ghana	Liberia	Morocco
• Delayed processing of guarantee applications by the CGS. • 3-4 years delays in processing of banks claims for compensations. • Administrative costs were higher than the income generated by the fund.	• Limits in amounts guaranteed were not adapted to inflation. • Reluctance of the CGS to settle banks claims resulted in delays. • Claims assessment capacity of the CGS was limited. • Banks did not pursue recovery of defaulted loans after being compensated by CGS.	• Low confidence among banks in the scheme. • Lengthy claim application process. • Disputes between banks and CGS on payment of claims and guarantee fees.	• Limited number and poor quality staff. • Poor loan evaluation criteria to approve guarantees. • Shortage of funds to compensate banks. • Payment on bank claims was decided on adhoc basis.

In addition to the potential lack of trust due to bureaucracy between MFIs and the government that is evidenced from the table above, government credit guarantee schemes suffer from the image of charity and acquired rights for the MFIs and end-use borrowers.

This does not mean, however, that governments do not have a role to play in the promotion of guarantee funds as an effective tool for expansion of outreach in the microfinance sector. In general, government can act at a national scale to benefit the existence and/or practices of CGS without interfering directly on the service offering side. To that end, the government role in CGS should be as a supporter and/or as a guarantor. It is also seen that governments, in some instances, play more than one role at a time, and to be different in the degree to which it practice a specific role.

As a Supporter, the government promotes conducive environment for the establishment and operation of CGS. In that regard, governments could offer tax preferential treatments to CGS, it can participate in the Board of CGS as part of active governance. This is specifically appropriate in countries where the government has already recognized the importance of MF as a fuel for national economy. Primarily, we have to point out that for CGS services to exist and flourish in a certain country, the role of government as a Supporter is considered a pre-requisite. As a Guarantor, the government could assist in CGS outreach by providing direct capital contribution in the CGS equity or even issue a guarantee to leverage the financial abilities of CGS

In sum, the experience in our region, conforms to CGAP principle for best practice microfinance which states that the government role should be an "enabler" rather than a direct service provider. **The evidence suggests that governments should not have a direct role in service offering, or even cast a shadow on a CGS facility. It is witnessed that in countries where CGS services are extended mainly through private sector funds that the fees for the CGS are competitive and banks are more interested to explore downscaling, benefiting the sector development in the long run. The**

Government's role is always needed as a supporter and even co-financier for CGS facility, provided that it actively contributes to governance but neither promotes its contribution nor exercises influential control over the CGS day-to-day management.

B.IV. Challenges To be taken in consideration when designing/operating a CGS

The following represents major issues that needs to be considered, either at the design or at the implementation phases for efficient CGS

Mission drift:
In many cases, credit guarantee schemes are designed as a tool to facilitate entry of FFIs to the microfinance sector, in that sense some CGS are designed with a pre-defined lifespan. However, the CGS may seek to change its temporary status by passing of time and look for reasons apart from the guarantee services to compliment or even to justify its continuity. CGS experiencing such situations is known to be drifting from its original mission; originally being a tool to proof a case for FFIs to entice them to allocate more resources to directly service the economically active poor

***Efficiency and Innovativeness*:**
CGS face a big challenge as they are required to be efficient and innovative in the same time. As far as efficiency is concerned, some MFIs had been comparing the cost of the guarantee fee against the amount of provisions made by the MFIs for loan losses. Assuming that an MFI is adopting best practice standards and fully provisioning its loans with instalments more than 90 days due; this MFI could expect that the provision would be close to its portfolio losses at the account closing time. Under these circumstances, the provision expense will be near to the guarantee fee, it is normally decided then not to approach CGS. This means on the other side that a good CGS has to strive for bringing its premium to the lowest possible rate, in order to be competitive in the market. Some practitioners believe that the profitability of CGS is questionable and favour designing temporary CGS over permanent facilities.

The second big challenge for CGS is the rapidly changing environment of MF sector in which they operate, especially as the MFIs' needs change overtime as they get matured or diversify their products. Accordingly, CGS has to allocate part of its investments towards market research and routine assessments of MFI needs, it should benefit from an effective Research and Development (R&D) function, whether by buying the service on an ad-hoc basis or employing it; this is subject to the size of and financial resources made available to the CGS as an entity.

Competition faced from international guarantee schemes:
One of the practical challenges faced by CGS is the fact that some international CGS has been approaching the market in the Middle East; an example is Grameen U.S. Foundation extending facilities to an Egyptian MFI, whereas a specialized CGS exists in Egypt[18]. With the international guarantors coming to the picture it will only be harder for locally initiated CGS to compete. Primarily because of the ability of international CGS to access well-developed re-insurance facilities, as well as its advanced management/reporting capabilities, and above all its financial soundness (credit worthiness) that is assured by international financial compliance and reporting standards.

Having said the above, and if we adopt a strategic orientation of having CGS as temporary intervention; it is logical to start thinking of securing an international CGS after examining the costs and benefits against the option of establishing a national or local CGS.

[18] The Credit Guarantee Company

The management interference and potential client re-targeting that the CG companies may practice over the guaranteed MFI:
This challenge is more caused by the lack of knowledge of the CGS on good practices of managing the risk of their MFI clients. This is witnessed when the CGS is tempted to go into the details of the MFI's operations. In some cases, and even though the CGS is extending a portfolio guarantee, it may be over-reacting to its exposure by interfering in the MFI operations down to the level of approving loan applications and/or approving regular business expenses. The situation may even be exacerbated by the CGS "suggesting" a better client group for the MFI that is "less risky" and the MFI accepting it; resulting in skewing even the mission and practices of serviced MFIs.

CGS should always employ high calibre personnel and be exposed to best practices in their respective area of services, in order to be able to stand beside international CGS, especially with the gradual openness of the financial market in Sudan to deal with international money markets.

B.V. Mutual Credit Guarantee Schemes (MGSs)

MGSs were the first schemes to be launched in the world. In these schemes, a number of enterprises make payments to a cooperative or any other form of business association (BA), which will then be prepared to guarantee loans taken out by any member up to a certain limit. Such arrangements have worked reasonably well in both developed and developing countries among farmers, artisans, and tradesmen. Their impact on the total volume of lending to small enterprises is small, but this does not mean that such initiatives are not worthy of support[19].

Unlike government funded schemes, members guaranteed by an MGS develop a sense of ownership of the fund and so their attitudes are more positive towards loan repayment, fund management and utilization.

MGS could be established as a fund within existing CBOs/BAs or as an independent mutual guarantee association (MGA) and an affiliate of an existing CBO/BA. Such guarantee associations differ slightly from country to country depending on a number of factors such as the legal framework, the state of development of the financial market, and the promoting entity. Nevertheless, they share certain general characteristics:[20]

1. The potential members of the MGS join because they do not have access to credit from banks;
2. They are promoted by BAs, chambers, or banks. Experience has shown that MGSs promoted by business associations are the most successful models, because these associations maintain good contacts with the targeted groups and tend to be well acquainted with the needs of their businesses.
3. Members of these associations share a common bond e.g. regional, industry, the same market, utilization of the same infrastructure. This is important for solidarity;
4. Members control the operations of the MGS and make collective decisions.

The most successful and powerful MGAs are to be found in the developed world where for example in Italy, the default rate was around 1%. Performance of MGAs in Africa (examples are to be found in Senegal, Ivory Coast, Guinea and Morocco) is mixed,. Those established in Guinea were the most successful: recovery rate was around 92.6% without using the guarantee fund and 98.4% after using

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[19] Credit Guarantee schemes for small and Medium Enterprises – Jacob Levitsky et al – World Bank technical paper No. 58.
[20] "Making Social Capital Work: Credit Guarantee Associations for Artisans" – Maria Sabina De Gobbi – Social Finance Programme – Employment Sector – ILO

the guarantee fund. The Moroccan MGAs were not successful because they were promoted by banks. The default rate for Moroccan MGAs was in the range of 10% -23%.

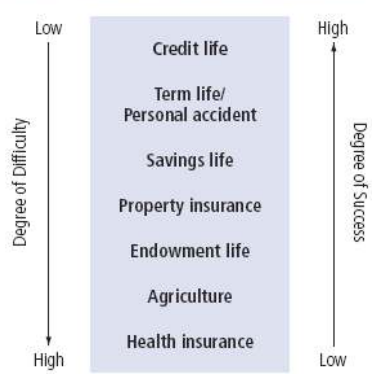
C. MICRO-INSURANCE: AN INNOVATIVE RISK MANAGEMENT STRATEGY?[21]

Micro-insurance is another innovative strategy that has been proposed for risk management and giving credit-worthy micro-entrepreneurs easier access to credit. Few poor households have access to formal insurance against such risks as the death of a family breadwinner, severe illness, or loss of an asset including livestock and housing. These shocks are particularly damaging for poor households, because they are more vulnerable to begin with.

Micro-insurance is the protection of low-income people against specific perils in exchange for regular monetary payments (premiums) proportionate to the likelihood and cost of the risk involved. As with all insurance, risk pooling allows many individuals or groups to share the costs of a risky event. To serve poor people well, micro-insurance must be responsive to priority needs for risk protection (depending on the market, they may seek health, car, or life insurance), Micro-insurance is a new product and still at the experimental stage. There is much interest among MFIs to provide micro-insurance in partnership with insurance companies. Such insurance products can be seen as complement to existing guarantee schemes because they cover the business risks linked to the micro-enterprises and the risks linked to micro-entrepreneurs' physical capacities.

The big challenge is finding the right balance between offering adequate protection with affordability for poor households. As shown below, several different types of insurance might be relevant for poor and low-income clients.

Most Common Types of Microinsurance Products



- Credit life insurance is the most common and ensures that "debt dies with the debtor." It is actually used to protect lenders, not the families, from the death of their clients and is often offered directly by MFIs. Term life or personal accident insurance is often offered alongside credit life insurance to cover the family if a borrower dies. Examples of this kind of insurance is the work of the U.S.-based insurance company AIG in East Africa and the Death and Disability Product implemented by Planet Finance in Egypt.
- Savings life insurance is often offered by credit unions and stimulates savings. Endowment policies combine long-term savings and insurance with emergency loans against the savings

[21] ACCESS FOR ALL, *Building Inclusive Financial Systems*, CGAP, 2006

balance. In this case, the premium payments accumulate value. Delta Bangladesh offers this kind of policy.

- Agricultural insurance is particularly tricky, and no evidence exists of viable programs. The problem is that insured farmers are less likely to pursue sound practices and therefore are more likely to lose their crops. It is difficult to calculate the probability of loss because so many factors can influence crop yields. At the same time, premiums that farmers can afford are not usually sufficient to cover claims and administrative costs. Recent innovations that link insurance to rainfall and other weather conditions are promising, because they may be more measurable, objective, and viable.
- Health insurance is probably the product for which there is the greatest demand among poor and low-income households; however, like agricultural insurance, it is difficult to provide this insurance viably.

CHAPTER 2

COLLATERIZATION & GUARANTEES: THE EXPERIENCE OF SUDAN

I. INTRODUCTION

The Experience with collaterals and their substitutes in the provision of Microfinance in Sudan is based on a field survey conducted in the three states of Khartoum, North Kordofan and Gedarif. These states were selected to portray the social, economic, and demographic variations under which microfinance is being practiced. The survey also observed the diversity of actors providing microfinance in each of the states (see Annex 2 for a listing of MF providers), covering both formal institutions (banks) and semi-formal ones (e.g. NGOs and CBOs), providing microfinance for both individuals and groups. Three Banks were selected for the purpose of conducting the survey, namely the Savings and Social Development Bank, the Agricultural Bank of Sudan and The Islamic Cooperative Development Bank. These banks were selected because their micro lending portfolios were the highest compared to other banks. In each of the three States the study team also covered NGOs, savings and credit associations, women organizations networks and other Civil Society Organizations (CSOs) practicing micro-lending, whether directly extending micro-credit or acting as financing intermediaries.

The survey of the three selected banks revealed that they apply – at varying degrees - the following types of non-conventional collaterals:

1. Third Party Personal Guarantee (TPPG): as a supplement to postdated cheque/s from the guarantor as a supplement borrower;
2. Donor loan guarantee funds;
3. Chattel mortgage ;
4. CBO loan guarantee fund;
5. CBO legal entity supplemented by post dated check;
6. CBO legal entity - CBO not legally liable for repayment;
7. CBOs pledge to hand over defaulting clients to respective banks; and,
8. Salary guarantee.

The NGOs/CBOs surveyed apply a variation of non-conventional collateral substitutes including:

1- Different forms of Third Party Personal Guarantees
2- Group collateral
3- Pawning
4- Blocking of savings as collateral
5- Holding ownership title till full repayment of loan
6- Signing a legal undertaking not to dispose of assets/commodities till full repayment
7- Pledging of future income, salary or pension as a collateral
8- Writing Promissory notes to secure repayment
9- Offering bonds as a form of collateral, used by some to obtain bank credit

Data collected from the field was tabulated and analyzed and the findings are highlighted in the following sections.

II. COLLATERAL SUBSTITUTES APPLIED BY MICROFINANCE PROVIDERS: STRENGTHS AND WEAKNESSES

Different collateral and collateral substitutes are used by banks, NGOs, CBOs and other institutions involved in micro credit operations in Sudan. The choice of a suitable collateral varies and depends on the nature of the organization/institution handling the microfinance operation as well as the degree to which it accords importance to such criteria as the client's track record, the guarantor's credibility, the easiness of collateral repossession. The following section discusses the various forms of collaterals after having grouped and categorized them to facilitate their discussion and to identify strengths, weaknesses, and constraints encountered by banks and other microfinance providers and the factors behind such constraints:

II.1. The Third Party Personal Guarantee (TPPG) is widely used by banks and other micro-credit providers to secure loans not exceeding ten thousand Sudanese pounds (SDG 10,000). In this type of securitization, the guarantor is required to issue post-dated cheque/s in addition to those issued by the borrower for repayment. The number of guarantor's cheque/s are equal to that of the borrower which in turn depends on the number of installments and the nature of transaction. For example, in financing agricultural activities, payment is made by one cheque after harvest. In all cases, the applicability of TPPG is conditional on both the borrower and the guarantor having a current, deposit or savings account with the concerned bank. Non-bank clients and those who keep saving accounts only, will be requested to open a current account with a nominal initial deposit. For financially incapable applicants the account will be opened without any deposit to allow the client to issue postdated cheques for loan repayment. If the guarantor is a client with another bank, the lending bank checks the performance of his/her account to verify credit history. Criteria for acceptability of guarantors by banks include financial capability, being well-known in the community, belonging to a reputable and/or financially capable family whose members would most likely intervene when and if legal procedures are taken against him/her (ABS Jebel-Aulia). Although it is evident that women, in rural areas, are generally keen to retain their good reputation in the local community, banks have not adequately built on this positive trait to influence repayment.

Third Party Personal Guarantees (TPPG) can be issued by individuals or legal entities such as grass-root savings and credit associations, cooperative societies, unions etc. It can take several forms depending on the conditions for issuing the supplementary guarantee, the number of guarantors and/or the number of borrowers being guaranteed. The different types of TPPGs can be summarized as follows:

1.1 Loans provided to individual borrowers where the lender requires *individual guarantors* to issue postdated cheque/s.

1.2 Acceptance of a *promissory note* from the guarantor instead of a post-dated cheque (e.g. SDF, in case of individual loans less than SDG 10,000).

1.3 *Two guarantors* may sometimes be required to guarantee an individual loan. Both guarantors would be asked to issue post-dated cheques. This is applied sometimes when bank officials consider the project to be risky (SSDB, Khartoum South branch).

1.4 Sometimes banks ask for *a number of guarantors* to allow them to select the most suitable one (a case in Gedarif where the ICDB asked for three guarantors) for securing an individual loan.

1.5 *An association* may issue a post-dated cheque as a guarantee for loans extended to its individual members e.g. the members of Microfinance Organizations Network (MON) financed by SDF and Gedarif Women Development Association (GWDA).

1.6 Individual loans are sometimes secured by *a guarantor plus two witnesses* (from a society's members), without the condition of guarantor's postdated cheque, e.g. the individual loans provided by the Cooperative Society for Food and Beverages Sellers (Haj Yousif, Khartoum North) to its members. In some cases, the recommendations provided by two members of a local lending association were considered sufficient guarantee. This type of collateral was implemented by OXFAM funded CBOs but it was considered unsuccessful.

1.7 In some cases, the TPPG is an undertaking endorsed by *a legal entity such as a cooperative society, a CBO, a farmers' union or a popular committee.* For example the collateral for loans extended by SSDB (Gedarif) to small farmers' unions for which the collateral is an undertaking endorsed by the General Farmers Union. The small farmers' union issued post-dated cheques to the General Farmers Union to obtain its guarantee. However, this type of collateral caused repayment problems to SSDB in Gedarif State and the average repayment rate for three branches of SSDB was only 77percent. This relatively low rate is partially due to the failure of the farmers to repay their loans and the reluctance of the guarantor (the Farmers General Union) to fulfill its obligations as guarantor. As a result of such negative experiences, most banks are hesitant to accept a *Third Party Guarantee issued by Community Organizations* such as cooperative societies or unions. However, some exceptions exist, e.g. SDF accepts the guarantee provided by grass-root savings and credit associations. The association signs a legal undertaking to pay in the event that a member defaults and issues a post-dated cheque as additional collateral. It is still premature to assess this practice and no proper evaluation has been conducted, to date, on SDF performance. It is to be noted that SDF experience in the provision of micro credit as a separate activity from its other social support services is a very recent one (2007). The *guarantee provided by Popular Committees* faces the same problem as that stated in the forthcoming discussion on local leaders' guarantees. An example is the experience of the Farmers' Commercial Bank in financing "productive families" in the Hasahiesa area where guarantees were provided by the PCs but repayment was very low.

The guarantee provided by a CBO may also take the form of an undertaking to hand over the defaulting clients to the lender. This type of collateral was accepted by five of the branches of the Agricultural Bank in North Kordofan which implement the credit component of the North Kordofan Rural Development Project, financed jointly by IFAD and the Government of Sudan. The acceptability of this form of collateral stems from the fact that the majority of CBO members are from rural areas and are not in a position to secure a personal guarantor of adequate financial standing. CBOs, in this case, were not required to issue postdated cheques and hence, they were not legally liable for the payment of the debt if any of the borrowers defaulted. Instead, the CBO leaders would sign an undertaking to hand over the defaulting client if the bank, intending to enforce the claim, could not get hold of the client. From a legal point of view, this type of collateral is inappropriate as, strictly speaking, the authority of bringing people for legal action resides with courts only and is implemented by police forces. Moreover, most of the CBOs failed to hand over the defaulted members to ABS because the majority of them are characterized by high mobility leaving the village for long periods at a time. El Obied ABS branch was one of the five branches which applied this type of collateral. Table (1) shows that the branch issued only one loan in 2006. This is because the portfolio at risk during 2005, carried to 2006, was very high reaching 71percent (table 2).

1.8 The *TPPG provided by local community leaders* is sometimes used as a guarantee for loans extended by a small farmers' union to its members. Some banks (SSDB and ABS), particularly in remote rural areas, accept the guarantee of a local leader (Sheikh, Omda, Nazir, Sultan etc.) who recommends borrowers and ensures that he knows them very well and will follow up on their repayments. No cheque or promissory note is required from the local leader and his word is the only guarantee. Similar to the previously considered guarantors, the *Omda or Sheik* is not legally liable for payment and his main role is to verify the credibility of clients and use his influence in collection. From their experience, the bank's officials consider it an effective guarantee as in many cases it failed as banks could not do anything if the leader failed to honour his commitment. Nonetheless, experience has also demonstrated that better repayment rates are achieved when such collateral is coupled with extensive follow-up undertaken with the assistance of the *Omda or Sheik* (the guarantor) because many local leaders are influential in their communities and some of them represent the native administration. The guarantee of *Sheiks* and *Nazirs* is currently applied by the SSDB in Northern Sate where the bank started applying this collateral in 1999 with farmers practicing flood irrigation after the rainy season. In seasons of high flooding, repayment on due date was not less than an average of 95%. Low repayments of 50% to 70% were always linked to low flooding and low production. Some believe that the guarantee of the native administration is reliable in some rural areas, where the *omda* enjoys a strong character, influence, and respect in the community. Linking the native administration collateral with the CBO collateral would be more appropriate in such communities.

1.9 In some cases *one person may act as a guarantor for 10 borrowers* and at the same time assists in repayment collection (e.g. Gedarif WDA). The guarantor must be a reputable person in the local community. No post-dated cheque is required.

1.10 There are some cases where the *TPPG, supported by a postdated cheque, is required as secondary collateral*, e.g. in some loan programs guaranteed by a deposit taken as a security of the guarantee fund as a principal collateral (e.g. Khartoum Province Women Union guarantee fund managed by SSDB);

The TPPG, when supplemented by a post-dated cheque, proved to be very effective in ensuring full repayment of loans, as borrowers and their families fear imprisonment in case they are taken to court. Leaders and members of women associations, who are engaged in micro-credit activities, explicitly expressed their fear of issuing postdated cheques. When asked why the fear, one lady answered "we are afraid to go to jail; we have families and kids to look after". On the other hand, it is reported that some banks have started to avoid the TPPG (ICDB Gedarif), describing it as problematic.

The major constraint encountered with this type of collateral is that in some cases when the customer defaults, it would be very difficult to get hold of either the client or the guarantor. <u>However, this constraint is mainly attributed to the inappropriate lending procedures followed by all banks, which do not conform to standard microfinance lending procedures</u> As it is clear from the steps followed by banks, visits to the business places of loan applicants are far from standard practices (See table 1). Banks depend, mainly, on formal documents such as business licenses and the residence certificates rather than visiting the business place for verification and for collection of information necessary for loan analysis that would have strengthened the collateral. <u>The establishment of a national civil registry system by the government would contribute to solving of the problem of locating clients or guarantors.</u>

<u>It is strongly believed that the strong reliance on TPPG, coupled with a postdated cheque from a guarantor, grossly limits the access of rural people to microfinance services provided by banks. This could be compared to the CBO collateral which is seen to be contribute to greater outreach. This is because, in most cases, it is very difficult for rural potential clients to find a personal guarantor acceptable to banks. Moreover, banks are concentrated in the urban areas limiting access by rural entrepreneurs.</u>

Table (1) Comparison of local banks lending procedures and practices with Standard Practice

Best Practice Lending Procedures and Practices	**Local Banks Procedures and Practices**
Stage 1: Loan Application and analysis	1. Loan Application
1. Client request information and submit application	2. Review of feasibility study prepared by the applicant
2. Business place visit: Loan application and business analysis at business place in participation with applicant	3. Verification of personal guarantor based on performance of bank current account
3. Review of loan analysis by other loan officers	4. Loan approval and disbursement
4. Management training optional	5. Balloon loan payment
5. Credit officer evaluation of client character	
6. Verification of cosigners	
Stage 2: Loan Approval and disbursement	
1. Preparation of documents	
2. Approval by the credit committee	
3. Contract signing and loan disbursement	
4. Verify purchases	
Post-disbursement Contract	
1. Monthly visits (optional depending on the client's credit history with the institution)	
2. Additional management training (Optional)	
3. Follow up loan repayment (Monthly payments & late payments)	

II.2. Group Collateral is another form of collateral substitute applied by a number of Sudanese non-bank organizations/institutions (banks have no experience in such type of collateral). It proved to be most effective among homogeneous groups, particularly in the rural areas. There are some cases where group collateral was adopted in urban areas to provide loans to the poor, e.g. by SDF and some INGOs (ADRA and OXFAM). SDF applied this type of collateral for sub-groups (5-15 members), within the registered cooperative societies that acted as links between SDF and target clients. Gedarif WDA also applies group collateral where a group of ten, guaranteed by one community leader, repays on behalf of a defaulting member. The repayment rate of loans extended by Gedarif WDA is over 95%. Each group usually keeps a savings fund aside to take care of repayment in case of a member's default. The group collateral is also used in rural areas e.g. by the village Sandugs of the North Kordofan Rural Development Project where the Sandugs receive credit from the ABS and undertake re-lending to target clients, using the group collateral plus other forms.

However, in some cases, this type of collateral was not successful. An example is the experience of OXFAM which provided seed capital (as a grant) to CBOs to manage the money as revolving funds for re-lending to its members (individual loans to groups of five members). The reason for the ineffectiveness of group collateral, in this case, could be attributed to the difficulty of shifting from relief to market-based lending i.e. OXFAM's target groups feel that this money is part of the relief which they are used to receiving from a basically relief agency.

II.3. Pawning: this is another form of collateral substitute that was successfully adopted by the SSDB in the mid seventies in the ex-central region. Another successful example in the adoption of pawning as a collateral is that of the ex-Eastern Kordofan Rural Council during the 1950s and 1960s, which used to lend money to rural households at the beginning of the cultivation season against pawning of jewelry.

However, more recently, only few organizations have been using this type of collateral. The Savings and Credit Associations in Gedarif tried to adopt the pawning collateral but were faced with a number of problems among which is the safe keeping of valuable belongings.

Nevertheless, the potential of this type of collateral is very good as some of the poor clients, particularly women in Sudan, hedge against unforeseen future economic crises by owning gold ornaments. Such ornaments, in addition to small size valuable personal belongings, could be pledged against loans if proper security arrangements were in place. An agreement could be reached with a local bank to keep such items in case of pawning. The past successful experience of the SSDB could be revived as well as benefiting from the experiences of MFIs in other developing countries e.g. SEWA Bank in India which immediately provides a loan equivalent to 80% of pawned items after the pledged item is valued by a goldsmith adjacent to the bank door.

II.4. The Blocking of Savings has acted as good and flexible collateral in many experiences in Sudan, mainly among grass-root savings and credit organizations. The Savings and Credit Associations in Gedarif (43 associations with a total membership of 2433, under the Umbrella of Women Savings and Credit Associations, which took over from SDA) adopt a regular savings program in which 20% of the loan amount is blocked from a female borrower's savings, in addition to 20% of the savings of two members who support her application (10% each). In this case, the lender's risk is reduced as the loan is secured by 40% from savings. The same practice is adopted by the Cooperative Society for Food and Beverages Sellers in Haj Yousif, Khartoum North, which extends loans from its savings and other self-generated income (rented sheds, video clubs). This type of collateral has been very effective and the repayment rate is, an average, 98%. Another example is that of Women Savings and Credit Associations financed by SDF. Ten percent of the loan is deducted by SDF and deposited in a pooled savings account in addition to one Sudanese pound (SDG 1) per week paid by the member borrower. These amounts are kept in a bank and used only in case of failure to repay. Savings are blocked by SDF till full repayment of loans.

Gedarif Women Development Association (GWDA) borrowed from the SSDB (SDG 64,000 in May 2007) to re-lend to its branch associations which re-lend to its members. Before receiving the loan, Gedarif WDA deposited 30% of the loan amount with the bank in advance. Each member association and each borrower was asked to deposit the same percentage with her organization. The savings fund was deposited with SSDB to act as partial collateral, in addition to a post-dated cheque endorsed by GWDA for the full amount of loan. Up to now the repayments are regular, as scheduled.

The blocking of savings, in addition to other forms of collaterals, is also used to extend rural credit by the village Sandugs operating within the North Kordofan Rural Development Project.

However, the experience of savings among groups with special needs, was not successful as they failed to collect savings from members due to extreme poverty prevailing among them. Such type of extremely poor people or destitute, are not typical microfinance clients. An example of this is the experience of the Disabled Persons Associations in Gedarif. Most of the "destitute" and "extremely poor" groups are considered by some as incapable of taking up self-employment activities, particularly when they lack the skills, entrepreneurial abilities and aptitude for such ventures. The handling of the problems of such group necessitates considering alternative strategies like, for example, finding appropriate wage employment.

II.5. Ownership Title: One form of *non-conventional collaterals is the holding of ownership title* by lender till full repayment of loan, or the borrower *signing an authenticated legal undertaking stating that the assets/goods are the property of the lender and will not be disposed of until the loan is fully repaid*. This seems to be a good form of collateral as it allows the lender to repossess the pledged goods when the borrower defaults. This type of collateral is applied by NGOs/CBOs engaged in microcredit activities.

The adoption of legal undertaking as collateral is not without problem. The use of such type of collateral by banks, e.g. in lease-sale financing, is quite limited. Four reasons are stated for this limited use: a) the goods/assets procured can not be officially registered; b) upon repossession of the goods by the lender, they are usually in a bad shape (depreciated) and are difficult to resell for a rewarding price; c) there is no guarantee that the borrower will not dispose of the procured asset/commodity inspite of the legal undertaking. In such cases, filing a legal suit against the borrower is the only option but that would entail cumbersome procedures and unjustified cost; d) repossession of assets by the lender is considered by some as socially unacceptable (SDF staff). Accordingly, some institutions, e.g. SDF, ceased to adopt such type of collateral.

Nevertheless, this type of collateral is used by the SSDB in financing the graduates' projects under the Graduates Employment Fund (GEF), which was established by funding from several banks. The management of the fund and lending to the graduates' groups was entrusted to the SSDB. Graduates who are interested to undertake private investments and who apply to the Fund receive training in business plan preparation and project management. Graduates of similar interest are usually organized into group enterprises (consisting of 3-five members) and each group registers its project under a business name. *Legal undertaking*s are signed by self-employed graduates when they borrow from the GEP (through SSDB). Individual undertakings are signed by self-employed graduates who receive loans which are strengthened by a post-dated cheque issued by their group enterprise (as a legal entity).

In this project, the SSDB Khartoum South branch issued thirteen loans, twelve of which were for group businesses and one for a business owned and managed by a graduate. The loan for each group was issued against pledging the business equipments and a postdated cheque from the business name and a postdated cheque from each graduate in the group. Of the thirteen loans, issued twelve were not successful. The branch manager attributed the failure to the inexperience of most graduates in business management, disputes among group members, and some of the investment ideas implemented were not viable. Another reason for this failure could be the emphasis of the GEP on group enterprises which, in many developing countries, achieved limited success. Another relatively unsuccessful graduates' enterprises' experience is in Gedarif State where the repayment rate is reported to be 57% only (Manager of SSDB Gedarif).

One form of legal undertaking is that when a merchant running a grocery business endorses an undertaking that the stock in the shop is owned by the bank till full repayment of loan. In addition to this the stock is insured (ICDB). Another form is when the borrower endorses an undertaking promising to repay a loan guaranteed by his/her organization e.g. loans extended by SDF to savings and credit organizations. The organization signs an undertaking promising to repay, in addition to issuing a post-dated cheque for SDF. Another form of this undertaking can be found in Gedarif where women (members of savings and credit associations) endorse an undertaking pledging to keep some home property to secure the loan received, e.g. a TV. However, when a default case occurred, the association tried to take the TV but the husband intervened and claimed that the TV is owned by him, not his wife.

This type of collateral proved to be a strong collateral when any of the following conditions were fulfilled:

a) When the loan is extended to an established well performing business. In such case, the owner would not be inclined, whatsoever, to sell the equipment;

b) When credit is provided to old borrowers who maintain a good credit history with the bank. The strength of the collateral in this case originates from the fact that such client would not be tempted to selling the equipments because selling them would mean loss of business.
c) The risk that the borrower may sell some of the equipment in response to a pressing need is mitigated by continuous monitoring of borrowers which is a standard microfinance operations procedure, especially for first-time borrowers. The

<u>Frequent visits and the advice delivered during these visits is a form of non-tangible collateral, which reduces the likelihood of default.</u> In the absence of proper means of clients screening and selection, the borrower's enterprise and cash flow analysis, such collateral would be very week and may not reflect adequate repayment commitment on the part of the borrower. <u>In microfinance, the principal function of the non-conventional collateral is to prove the borrower's commitment to repay rather than a means of loan recovery.</u>

II.6. Pledging of Future Income as Collateral is practiced by some micro lending institutions. This type of collateral is adopted in three different forms:

a) The acceptance of *salary as collateral* is practiced by some Sudanese lending institutions e.g. SDF, the Farmers Commercial Bank, ABS (for consumption loans) and some local savings and credit associations. This is one of the best collaterals in case the borrower or his guarantor is a salaried employee. However, this collateral would be stronger if the employer submitted a letter of guarantee to ensure deduction of installments from the employee's salary (a good example is a microcredit program implemented in Ahmed Gasim Hospital in Khartoum North, in which micro loans were provided to Hospital workers to engage in income-generating activities guaranteed by their salaries/wages, in coordination with hospital authority).

b) *Using pension as collateral* to issue microcredit to pensioners. Recently the Arab Authority for Agricultural Investment and Development has donated a loan guarantee fund to be utilized by SSDB for extending microcredit to retired public institutions employees in North Kordofan State, in order to invest in income generating activities. In addition to the guarantee fund, the bank takes the monthly pension as collateral. Arrangements were made that the monthly pensions would be transferred for loan payment, which is repayable in two years. The program is still new and about to be implemented so it is too early to make a judgment. Another example is that of the Pensioners' Fund which provides microcredit for income-development activities using the pension as collateral.

c) *Deduction from future crop revenue* was also used to guarantee repayment of consumption loans extended by the Farmer's Commercial Bank to farmers' production committees in the Gezira scheme during 1994-1997 for supplying their villages with water and electricity services. The production committee in each village signed a contract with the bank to fund the supply of water and electricity services to interested village households. Each household head signed an undertaking to deduct his share in loan repayment from cotton proceeds. The program was very successful in terms of repayment and it contributed appreciably to supplying many households with water and electricity services. The success of the program in terms of repayment was mainly attributed to the fact the farmers deliver their cotton crop to the Gezira Authority for marketing. This form of contract is similar to the interlinked contracts but instead of delivering a commodity to the lender, in return to the loan, the lender receives the loan repayment in cash from a third party that is responsible for marketing of the crop.

II.7. **Accepting Promissory Notes as a Guarantee** for repayment is used by SDF to extend loans to individuals within groups. In such case, the group head and one member issue promissory notes as a guarantee for loans provided to group members. In case of default by one member, the group members are collectively held responsible for repayment. In lending directly to individuals, the SDF requires writing promissory notes by both the borrower and guarantor, instead of post-dated cheques by both. The borrowers issue promissory notes or bills reflecting the amount borrowed, the profit margin, repayment schedule and repayment dates. However, experience has demonstrated that clients are hesitant and reluctant to provide such type of collateral, as many of them consider it as socially unacceptable. According to views expressed by SDF officers, they prefer to issue post-dated cheques. Clients obtaining credit from the village Sandugs operating within the North Kordofan Rural Development Project also sign promissory bills as collateral, in addition to other forms of collaterals,

II.8. Offering Bonds as Collateral, is practiced by some financing institutions in Sudan e.g. the experience of SDF with the ICDB (Islamic Cooperative Development Bank) in which SDF provided "Shahama" bonds as collateral for obtaining a three years Mudarabah loan from the bank.

II.9. **Chattel Mortgage**, one of the conventional collaterals, is used in rare cases by banks to extend small loans, particularly when the value of the procured asset is less than SDG 10,000 e.g. in the case of a "Pajaj" or a mini vehicle (i.e. a rickshaw). Registering of such movable assets could also be used in extending small and micro loans for business purposes, including maintenance of vehicles (procurement of spare parts). Insurance of such vehicles adds to the security of the lender. The value of such collateral should be at least 125% of total debt (principal plus profit margin). This type of collateral is good as it doesn't require pledging of other tangible assets (which most of the poor do not possess);

II.10. Merchandize Mortgage, is another form of conventional collateral, applied by banks when financing working capital (e.g. raw materials), usually for medium and big enterprises. In few cases it is applied to extend small and micro loans but banks consider the transaction costly or unrewarding. Such type of mortgage is referred to, by some bankers, as "direct storage' of goods/commodities procured from the loan money.

III. THE EFFECT OF COLLATERAL ON MICROFINANCE PERFORMANCE

Table (3), at the end of the chapter, shows major types of collateral and their average share in micro lending in Sudan. It is clear that the third party guarantee, in its different forms, is the most popular collateral adopted by banks in lending to micro and small entrepreneurs [loans not exceeding ten thousand Sudanese pounds (SDG 10,000)]. During 2006, the total share of loans issued against TPPGs was equal to fifty six percent while the amounts disbursed against this collateral accounted for seventy five percent of total micro lending in that year. The share of individual lending for the same indicators was eighty four percent (84%) and ninety four percent (94%), respectively.

Table (4) reflects recovery rates and loan portfolios at risk, related to different forms of collateral used to secure loans. During 2006, the recovery rates, for all interviewed microfinance providers, were in the range of 4 percent to 82 percent with the highest recovery being that for loans secured by TPPG post dated cheques. The results for Portfolios at Risk (PAR) do not fare better, being in the range of 7percent - 71 percent, and again those using third party guarantees show the lowest PAR. Loans guaranteed by Donor funds which are the second most popular form of micro-loan disbursement (as shown in table (3)) above show dismal recovery rates and PARs.

It could be concluded that, irrespective of the type of collateral used, the overall performance of most bank branches visited is below average compared to international microfinance standards.

BOX (2) The Case of North Kordofan Rural Development Project (NKRDP)

NKRDP is a rural development project funded by IFAD (2002-2008). It contains a rural finance component which is implemented by ABS. Village institutions (CBOs) participate in the execution of the credit component by acting as financing intermediaries to link clients with eight ABS branches.

Providing credit to rural CBOs that perform the role of financial intermediaries between microfinance institutions and their memberships is one of the most effective methodologies to expand the microfinance outreach to reach clients in remote rural areas with a low population density. But the success of such outreach depends, to a great extent, on the delivery mechanisms adopted and particularly on collateral arrangements. In this box the experience of CBOs with the NKRDP will be highlighted in some detail to draw conclusions that may be built on in similar future experiences.

In extending credit to clients, through CBOs, the ABS uses several collateral substitutes at the same time. These substitutes comprise the CBO as a legal entity, post dated cheque from the CBO, in addition to close monitoring, as indirect collateral. With the exception of the ABS branches of North Kordofan and the SSDB branch in Gedarif none of the sample branches surveyed provide credit services to CBOs against the CBO collateral.

According to the practice of ABS in Bara and Um Ruwaba localities in North Kordofan, the village Sandug (as the intermediary CBO) should fulfill the following conditions to be eligible for borrowing:

a) To register as a business name (village Sandug).
b) To open a current account with the bank in order to deposit members' shares, savings, annual contributions, and income from lending.
c) Recovery of previous loan should not be less than 90%.
d) Members' savings collected should not be below 80% of the amount required to be collected according to the monthly installment to be paid by member as decided by the general assembly of the Sandug.
e) To satisfactorily implement a sound credit management system, credit by-laws, delinquency management procedures as per the manual specifically prepared by the Project for the CBOs.

At the CBO level, the CBO lends to its members against the following collaterals:

a) Group collateral, supplemented by members' savings. The village Sandug membership compose subgroups of 10-20 members. Upon formation of the group, the group members' sign an undertaking that they are liable for repayment of loans of defaulted group members.
b) A Promissory bill is signed by borrower.

NKRDP performance report reflected that the total number of Sandugs which borrowed during 2006 amounted to 84. The total membership of borrowers, for the same year, was 4269 persons, and the total funds lent from bank and Sandugs resources amounted to SDG 752,179.600. The overall repayment for 2006 was 71 percent, the portfolio in arrears was 14%, and the portfolio at risk was 5.5 percent. The table below groups the different Sandugs according to their repayment performance:

Grouping of Sandugs according to Repayment Performance

Indicator	Recovery rate range			
Recovery Rate range	90% - 100%	80% – 89%	70% -79%	< 70%
Percentage of Sandugs in the range	37%	14%	2%	47%

According to the report, and from the interviews held by the study team with ABS, some of the important factors behind the high arrears were as follows:

At ABS branches level:

i. The branch managements do not carefully check, whether the committee is applying the credit rules in terms of: loan eligibility criteria; members' savings collected (Savings collected during 2006 represented 33 percent of the planned volume); and the enforcement of the village Sandug claims against defaulted members through the village courts utilizing the promissory notes signed by members.
ii. In several instances branches either delay loans or reduce number of loans due to shortage of funds. In many cases, the shortage of funds has been the result of using the funds contributed by the project for the village Sandugs to lend other bank's clients. This attitude has adversely affected the relationship between the bank and village Sandugs, and has contributed negatively to loan recovery rates. The client expectation of access to a future loan is the single most significant incentive for repayment of a current loan.

The above explanation of low recovery rate demonstrates that a good client service is a form of non-tangible collateral which is of significant value.

At the CBO level:

i. The committees are not serious in collecting the savings because ABS savings products are without return;
ii. Most CBOs are not applying the delinquency management tools, as they are currently:
    - Not applying the penalties against defaulted borrowers;
    - Lending to members without considering their credit history with the CBO; and,
    - Not using the promissory bills to enforce claims though local courts.
    - Instead of applying strict delinquency management tools, they adopt lenient procedures.

The collateral substitutes of the CBOs, members' savings, and promissory bills would be effective and strong collaterals if both ABS and the CBO committee applied the credit rules. These collaterals should also be supported by additional collaterals like the pledging of animals, other household assets, and pawning of gold and silvery jewelry. Focus group discussions conducted with members of the "Sanduq" of Kadrouka village in Umruwaba locality of North Kordofan, confirmed the possibility and effectiveness of pledging livestock and household furniture and pawning of gold and silver jewelry. Stories were told that during the 1950s and 1960s, the then Eastern Kordofan Rural Council, used to lend money to rural households at the beginning of the cultivation season against pawning their jewelry. The money borrowed was used during the cultivation season to cover cultivation and household expenses and repayment was made after harvest. However, unfortunately no documentation was made on performance of this experience.

To strengthen the CBO collateral, minimum requirements and standards of performance should be set for CBOs intending to assume financial intermediation roles. To be eligible for borrowing from banks, a CBO should meet a set of minimum basic requirements and performance standards. Applying such regulations would render the CBO collateral, as a legal entity, with other supporting collaterals, more strong and effective.

There are two important minimum basic requirements in this respect:

- That a CBO should have and adopt a user-friendly, simple, yet comprehensive manual that contains sub-manuals for credit and savings, accounting and financial management, all detailing procedures, controls and systems involved, a loan recording system, effective risk and delinquency management procedures;
- Its members should be well-trained to apply the system;

Moreover, **to encourage CBOs members and committees to collect savings, banks should design attractive savings products to enhance/encourage savings mobilization.** Funds mobilized through savings constitute a cheap source of loan funds, the return on them would give many borrowers the incentive to maintain a good relation with banks and they will positively impact on loan recovery and operation cost.

IV. THE EXPERIENCE WITH MICRO-CREDIT GUARANTEE FUNDS IN SUDAN:

The field survey revealed that there are about ten credit guarantee schemes under operation within the banks surveyed. The funds used in these schemes have been donated by government bodies, private companies, INGOs, regional multi-governmental companies, and international donor organizations. All the guarantee funds are managed by the Savings and Social Development Bank (SSDB) as government and donor agencies have entrusted the bank with the task of lending to their targeted beneficiaries by virtue of its mandate. The table in Annex (1), reflects the names of donors, amount of funds, date of establishment, cumulative lending, & number of loans and claims paid against defaults.

In establishing a Credit Guarantee Fund (CGF), the donating agency usually enters into a cooperation agreement with the bank to provide the targeted beneficiaries with loans on a continuous basis. The duration of most agreements is two years, being renewable subject to successful performance of the lending program being secured by the guarantee fund. In each agreement, details highlighted, include: tasks handled by the bank in the lending operation; tasks handled by the donating institution; profit margin charged; and, loan duration. Features of all agreements are more or less similar, with profit margins ranging between 8 percent and 10 percent per year.

The bank provides finance equivalent to 150 percent of the guarantee fund. The donor/lending agency always nominates borrowers to be covered by the guarantee fund, except in Sudatel fund, which is donated to the Women's Union to be used as guarantee for loans extended to poor women heading their households. In addition to the security of the guarantee fund, the bank requires targeted borrowers to issue postdated cheques equal to the number of loan installments. In addition, the Women Union Guarantee Fund requires a personal guarantor acceptable to the bank. This may limit access of the worse-off women to loans as, in most cases, these women are unable to identify acceptable guarantors.

IV.1. Management and Performance of Guarantee Funds:

All guarantee funds in Sudan are managed by the SSDB and none of them generate sufficient income to cover administrative cost and losses against loan defaults. This is because with the exception of the IRW Fund, other funds are not deposited in time deposit accounts and they do not earn income from loans provided [The Islamic Relief Fund receives 2 percent of the 10 percent charged by the SDDB on loans].

Annex (1) table reflects the performance of the loans issued against the guarantee funds. Some of the funds were established only in 2007 and thus it is too early to assess their performance.

Among the funds established prior to 2007, the performance of the Solar Units fund is relatively better than others. This can be attributed to two factors; first the solar units provide borrowers with a basic service. Secondly, the units are pledged to the bank by an ownership document until full repayment of loan so the bank can confiscate the unit in case of default. Moreover, the economic life of the solar unit is relatively long and its value is affected by use. This demonstrates that equipments, of similar characteristics, could constitute strong collateral.

It is also clear from the table that when the guarantee fund is provided by a government body (e.g. localities) or a relief agency, the performance is very poor as borrowers consider this as a gift provided by the government or foreign donors. The repayment of borrowers in the localities of Omdurman and Ombadda, for example, was very poor in the first round of lending. Moreover, the lack of clear and detailed lending policies, in addition to the inexperienced locality staff, had contributed to low repayment rates (ranging between 10 to 70 percent at best).

On the other hand, when the guarantee fund is provided by an agency of developmental orientation (e.g. the experience of FAR and the GEF fund for financing solar energy appliances, both implemented in collaboration with the SSDB), the performance is much better as the guarantor exerts an appreciable amount of effort in training the potential clients, screening projects/clients, undertaking close monitoring and follow-up of borrowers. Another example of good performance is the guarantee fund donated by Sudatel to the Gedarif Women Union. This fund guaranteed loans issued by SSDB Gedarif branch to women entrepreneurs who were selected and trained by the women's union.

The percentage of defaulted borrowers in all the funds, as of June 2007, was 47 percent and the overall portfolio at risk was equivalent to 63% of the sum of funds donated. Lending against Khartoum State fund and the farmers union fund has been suspended and the funds were foreclosed in 2007. The low overall level of performance could be explained by several factors, some of which pertain to the way in which the funds are managed and include the following:

1. With the exception of the processing of the loan application, procedures prior to loan disbursement, which involve clients' assessment/selection and assessment of the investments for which the finance is requested, are performed by the guarantor institution. Monitoring of borrowers is a shared responsibility but because most bank branches only have one investment officer to do the follow-up this is not done consistently.

2. The most striking feature in all the funds is that the risk is fully borne by the guarantee fund, with the exception of the solar fund where the bank shares 10% of the risk of the loans disbursed. This encourages branches to rely on CG without exerting enough effort to make proper loan analysis, monitor borrowers, and apply effective delinquency management procedures after loan disbursement. To date, the bank has not taken legal procedures against any of the defaulting borrowers as it is the general belief that small loans do not deserve the effort and cost of judicial enforcement procedures which sometimes exceed the cost of the loan itself. This is contrary to general microfinance practice[22].

3. Another important factor behind the poor performance of most of the guarantee funds is that many of the guarantor institutions (i.e. institutions donating the guarantee money e.g Sudatel, localities, the Arab Agricultural Authority), are implementing tasks beyond their mandates and technical and operational capacities e.g. clients selection, training in business management and marketing and preparation of business plans. Entrusting the management tasks borne by the guarantor institutions to international or local NGOS with proven experience and efficiency would have been a better option. The story of the experience of the IRW, in Box No. (3), is a good example.

4. The guarantor institutions assume all the targeted beneficiaries possess entrepreneurial aptitude while most of those benefiting from the guarantee funds for the establishment of new businesses have very limited or no business experience.

5. Some of those benefiting from the funds have been receiving donations from these institutions before they were assisted to establish their own businesses e.g. clients of the State Ministries of social affairs, Khartoum State Fund. In addition, some of the loans were disbursed in a way that may serve political objectives, rather than encourage market-based lending practices (e.g. in-

[22] "Client-focused lending" which reviews the practices of 5 of the most renowned MFIs in the world; two of which are Alexandria Business Association Microfinance program and Bank Rakyt Indonesia.

kind items were distributed to borrowers in a public festival). This might have encouraged the borrowers not to repay the loans.

6. International experience has shown that guarantee schemes are most successful when lending micro and small entrepreneurs who have a good reputation and/or good standing credit history. In fact, some of these schemes refrain from securing investments with high levels of risks. However, in the case of loans secured by guarantee funds managed by the SDDB, most were made to clients undertaking new investment initiatives, without consideration to previous experience or credit history.

Box No. (3)

The CGS implemented by the IRW in Elobied

The experience of the credit guarantee fund of the Islamic Relief Agency in El-Obied is a different case compared to the other funds. The inauguration of the fund was in February 2007. Women benefiting from the fund were organized into groups of 20-25 members with groups structure being based on residential areas. Once the group is formed, each member is required to open a savings account at the bank with an initial sum of not less than SDG 5. In addition, each member is required to pay a small monthly contribution. Groups receive training in business management, marketing, and simple bookkeeping. The loan is repaid on three monthly installments. Once the group member receives a loan from the bank, she should continue depositing monthly savings in her saving account at the bank to accumulate enough funds to meet the loan payment obligation. The loan installments are deducted every three months from the savings account. Female borrowers have no idea that their loans are secured by the fund deposited by IRW at the SSDB. To date 87 women have received loans. The loan sizes are in the range of SDG 500 – 2,500. The loan duration is 18 months at a profit margin of 10% per year. With the exception of three loans, the recovery rate for all the other loans is in the range 90% - 100%.

V. MICROFINANCE AND THE INSURANCE POTENTIAL IN SUDAN

The experience of Sudanese MFIs and insurance companies in relation to microfinance transactions has been very limited. Most of the insurance covering productive assets has been taken up by large enterprises and in the case of banks for large loans. Insurance products, being offered by large companies such as the government owned Shaikan Insurance Company, are diverse and include such services as the protection of productive assets against accidental damage, theft, fire, civil havocs, natural hazards/disasters, death of animals, crop failure, road transport risks, business interruption due to civil upheavals, life and disability insurance, accidental machinery and electronic breakdowns not resulting from tear and wear, and insurance against misuse of funds by an entrusted person (fidelity guarantee insurance) and so forth.

Life and disability insurance could be especially beneficial for borrowers, if included in the lending package for small and micro borrowers. If a borrower is insured, the insurance company becomes responsible for repayment in the case of death or disability. Group life insurance, as explained by an official of Shaikan Company, is more convenient for micro-borrowers as it provides clients with simple payment options. Shaikan official gave an example of a group of teachers that are currently in the process of obtaining a group life insurance. A teacher pays a monthly installment of SDG 2.5 and his/her family becomes entitled to SDG 3,000 in case of their decease.

One of the few experiences that Shaikan Company has in micro-insurance is that provided for sheep procured by poor female borrowers in the microcredit project implemented by Plan Sudan INGO in collaboration with the Sudanese Savings and Social Development Bank in 2001. The project was implemented in the north-western part of the White Nile State which is a graze land for cattle herders and is the second biggest market in Sudan for sheep. Two hundred poor women were provided with 1400 heads of sheep (seven each, 2 ewes and 5 lambs) on an 18 month loan basis. All the animals were insured with Shaikan at a rate of 5 percent of total value (SDG 100,000). This rate was considered reasonable compared to the death rate in that environmentally fragile area which in some drought years may reach 15 percent. The insurance covered theft, death and ewes "miscarriages'. The project was implemented for two years only and then aborted by a sudden change in Plan Sudan policy (a negative shift from market-oriented lending to subsidies and grants). The experience was successful as the Bank was able to collect at least 90 percent of the loans. A major benefit emanating from this experience is that it created awareness among the rural community as to the possibility and importance of insurance.

The table (2) below reflects limited details of some of the insurance products provided by the Company.

Product	Cost of Insurance	Remarks
Insurance of assets against fires	0.008 + other fees	It could be for one year or several years but at a higher cost.
Machinery, equipment, and electronic equipment against accidental breakdowns.	0.008	
Insuring livestock against death, theft, and abortion.	7.5%	It could be provided for livestock in the village. Compensation is 90% of the insured value. Theft is not covered if it occurred during grazing.
Deaths and disabilities	The cost according to the insurance value and the level of susceptibility of the insured person.	The cost is higher for persons with higher susceptibility to death or disabilities.

Moreover, a project concerned with credit insurance, called "bond insurance", which covers borrowers' default (regardless of reasons for default- whether anticipated or not), is being considered by Shaikan Co. However, the idea of credit insurance has not yet been approved by the company's "Sharia advisory board", the role of which is to ensure the compliance of transactions with Sharia jurisdictions. The board stated that such insurance could only be adopted, as a form of solidarity action, without collecting any fees from borrowers. Nonetheless, the issue is still being debated.

The Islamic Insurance Company (IIC) has another experience related to credit but is confined to loans extended to employees of different institutions who obtain credit for procurement of vehicles or real estate (mainly houses), which are mortgaged by these lending institutions. In 2005, IIC launched a project called "Mortgage Protection Plan" for insuring these mortgages, in case of death or disability. In such case the lenders would not resort to mortgaged assets as the ICC will take care of full repayment or the remaining balance of the loan, according to this project. IIC has tried to market the idea to several lending institutions but no prompt response has been received yet.

Table (3) Number of loans, number of beneficiaries, and lending volume for each type of collateral

Types of collaterals	No of Loans	No of beneficiaries	Lending volume	% of # of loans	% of #of beneficiaries	% of lending volume
Individual Lending:						
Personal Guarantee	1,460	1,460	4,485,285	56%	47%	75%
Salary Guarantee	17	26	28,600	1%	1%	0.5%
Donor Guarantee Fund	1,139	1,139	1,084,600	43%	36%	18%
CBO Guarantee*	*1*	*1*	***1,000***	***0.04%***	***0.03%***	***0.02%***
Subtotal	***2,617***	***2,626***	***5,599,485***	100%	84%	94%
Lending to CBO:						
Guarantor CBO	7	429	334,468	0.27%	14%	6%
CBO Guarantee Fund	2	72	46,240	0.08%	2%	1%
Subtotal	***9***	501	***380,708***	0.34%	16%	6%
Total	***2,626***	**3,127**	***5,980,193***	***100%***	***100%***	***100%***

*CBO not legally liable for payment

Table (4) Quality of loan Portfolio according to Collaterals for bank branches surveyed as of 31/12/2006

Banks and collateral type	Recovery Rate	% of Portfolio at risk
SSDB		
Khartoum South branch		
Personal Guarantee (Branch funds & Graduates fund)	43%	30%
Credit Guarantee Funds	25%	26%
El Obied Branch		
Personal Guarantee supported by postdated cheque		0%
Credit Guarantee Fund	4%	8%
Agricultural Bank of Sudan		
Jabal Aulia		
Personal Guarantee supported by postdated cheque	82%	14.7%
El Obied Branch		
Personal Guarantee supported by postdated cheque	63%	7%
CBO Guarantee -CBO not legally liable for payment	47%	71%
Guarantor CBO + Postdated cheque from the CBO	49%	7%
Islamic Cooperative Development Bank		
El Obied Branch		
Personal Guarantee supported by postdated cheque	65%	0
Gedarif Branch		
Personal Guarantee supported by postdated cheque	77%	13%

CHAPTER 3

LEGAL ASPECTS OF GUARANTEES AND SECURITIES USED IN MICRO FINANCE: THE SUDANESE CASE

The previous chapter discussed the different forms of existing collaterals, guarantees and insurance services associated with microfinance and analyzed their effectiveness, strength/ weaknesses and flexibility. This section considers the issue of collaterals in microfinance from a legal perspective, by analyzing the relevance of some of these guarantees to the existing legislations, laws, and regulations.

From a legal point of view, the collaterals in use today can be divided into two principal forms, these being *Real securities* and *Personal securities*. Real securities require some form of property while Personal securities usually require a person who will stand surety for the debt. As shown in the previous chapter on the experience of Sudan, the choice of collateral depends mainly on the type and volume of financing provided to the entrepreneur as well as on the nature of the financial institutions (Bank- civil society organization or community based organization ... etc.). Moreover, the adopted collaterals and/or their substitutes also vary according to the social and cultural background of the communities being served.

I. Real Securities

All real securities revolve around one idea, which is to provide a strong guarantee that the loan will be repaid. Real securities are legally powerful as they are effective in reducing the risk of default and provide stronger guarantee of repayment than the personal ones. The two legal forms of collateral, - personal and real – are not necessarily substitutes to each other as they can be applied in combination as seen in the experience of both banks and civil society organizations.

The Mortgage - (Real Estate Mortgage):
The Sudanese civil transactions act 1984 defined 'Mortgage' and stated its rules in articles (727-784)[23]. Accordingly, 'Mortgage' ensures that the mortgagee recovers his money from the mortgager and is granted priority in obtaining monetary compensation from the pledged asset. Yet this right does not allow the exploitation of the borrower. This type of legal security is considered to be one of the strongest types of collaterals, however, financial institutions, community based organizations and associations working in the area of microfinance target poor sectors of the population in rural areas and the outskirts of towns who by definition do not own real estate or own land that is not officially registered. Moreover, legal fees required for registering real estate or land for mortgage purposes are prohibitively costly.

However, the provisions of 'Mortgage' in the Sudanese civil law also include mortgage of various types of movable assets - ***Chattel mortgage***.[24] Such mortgaging requires official registration and can be linked to micro finance transactions. The best examples for the use of this type of collateral is seen in the financing of purchase of commercial cars such as 'Albaggag motorcycles' (better known as Alerakecha) and small passenger cars, 'Amjad'. This type of Mortgage is a powerful legal collateral as

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[23] 'Mortgage' is a contract by which the creditor acquires real right on an immovable property allotted to the payment of a debt, and whereby the creditor shall have a priority over the ordinary creditors and the successive creditors ranking in the register, to recover the debt from the proceeds of sale of the mortgaged property in what ever hands it may pass) article 727 Sudanese transactions act 1984.

[24] Application of Mortgage provisions in the pledge of movable assets(article 738 Sudanese transactions act 1984)

it depends on more than one guarantee - starting with the contract followed by the postdated cheques for the total amount of the purchase in addition to the transfer of car ownership to the beneficiary only after full repayment of the loan. Moreover, the car insurance represents a further guarantee for the lender.

Pawning (Pledging[25]):

Legally, 'Pawning' means the pledging of property owned by an individual as security for a loan, with the property left with the creditor (the pledgee), or a mutually agreed upon third party, until the loan is fully repaid. The pledgee has the right to invest the asset, after approval by the pledger, and to deduct the profits of such investment from the loan amount. It is worth mentioning that pawning is more comprehensive than real estate mortgage because it can be applied to both movable and immovable assets.

Pawning, as a real security, takes on different legal forms in microfinance. For example, the seizure of the borrower's movable asset by the creditor (chattel mortgage) as security for the loan and that may not even be directly linked to the purpose of that loan. Chattel mortgage is a particularly strong legal guarantee especially if the pledged items are not quickly depreciable and maintain real value over time (such as jewelry). This is in addition to its real social and psychological value.
However, a recognized drawback in the adoption of such collateral is that the procedures and conditions related to this method are not clear, in addition to the complications that are linked to the capacities of the organization adopting this system, in particular:

- The lack of adequate safe keeping measures on the part of the pledgee which has constrained the use of valuables as collateral.
- The possibility of a third party claiming ownership of the movable assets being pledged. This raises the need for legal documents of ownership of these assets which may make it difficult for the poor.
- The doubt and mistrust that can emerge between pledger and the pledgee on the estimation of the real value of the mortgaged item.

II. Personal Securities

In principal and from a legal perspective, any property owned by the debtor can be considered a guarantee against the loan but to reduce the risks of default or failure to repay by the borrower, whether intentionally or due to reasons beyond his control, personal securities are used as additional guarantee. Accordingly, the creditors has the guarantee of the debtor as well as the surety, both of whom are legally liable for the repayment of the loan. The Sudanese law deals with two types of personal security contracts: the ***Surety*** and the ***Assignment or the transfer of a debt.*** In considering microfinance transactions, the former legal form, i.e. surety, is the most commonly used method of personal security by banks as well as other institutions microfinance providers (grass-roots organizations - cooperative societies... etc.).

Legally speaking, ***surety***[26] is a person or corporate body[27] who pledges that another person's obligations will be met in case of default, in which case the surety can commit himself either by

[25] The 1984 Sudanese transactions act stated the pledge rules in part 21 chapter 2 articles 766-798. Accordingly, the pledge is a contract whereby the creditor or receiver retains possession of the property as a security for a loan until repaid partly or in full, in priority to all other creditors - article 766**.**

[26] The 1984 Sudanese transactions act defined surety in article 484 as a contract whereby a person binds himself with another person to fulfill an obligation due from such person to a creditor.

[27] The 1984 Sudanese transactions act stated in article 17: "persons are of two types natural persons and corporate bodies" which means surety provisions include both of persons types.

repaying the loan in case the debtors failed to repay, or by bringing the debtor to the creditor **(*surety for appearance of a person*[28])**. As shown previously, the most common example of this type of collateral is that used the credit funds of the village development committees of the Rural Development project in North Kordofan.

The Third Party Personal Guarantee (TPPG), which was considered in detail within the collateralization experience of microfinance institutions in Sudan, is considered to be a clear **surety**. From a legal perspective, this collateral proved to be efficient in ensuring full repayment due to the following reasons:

- The existence *contractual obligation* as reflected in the Murabaha contract signed between the bank and the client.
- The use of *postdated cheques* as a means for ensuring repayment leads to clients' fear of exposure to prison in the event that the case is brought to court.
- Surety is used in the sense of *financial* surety i.e. the surety is personally responsible for repaying the loan if the borrower failed to do so.

The TPPG is used for individuals as well as legal entities such as CBOs, cooperatives, professional associations etc, and it is used at two levels: (a) When the guarantor association or organization, as a legal entity, guarantees a loan to be provided to its member through the issuance of a postdated cheque to the creditor institution (example: the Microfinance Network of Khartoum State, Women Development Association in El-Gadarif, and the Agricultural Union in the provision of loans to small farmers); (b) When the legal entity accepts sureties for its members. Example of this case includes:

- The acceptance of its *member's sureties in the presence of witnesses.*
- The use of *cheques as a guarantee* tool in case of big legal entities that include smaller legal entities (example Farmers Union, and the Small Farmers Union).
- *Legal undertakings* and *declarations***,** either for repayment of the loan or bringing the borrower to the creditor.

Group Collateral, used by several <u>non-bank</u> MF providers, has two forms; the first one is when the MF provider accepts one personal guarantor for several borrowers in which case the guarantor should be of good reputation and well known in the community. The surety also assists in collecting the loan payments and is responsible for full loan repayment. The second form of group collateral is the solidarity or joint liability group collateral, in which case each member guarantees other members in the group. *Legally speaking*, members of the group cannot be considered as sureties since they themselves are borrowers. The guarantee is the collective commitment of the group members, and there is no surety in the known sense of the term. This particular type of collateral has proved its effectiveness especially in rural areas and among homogenous groups (sharing the same ethnic background, neighborhood, or performing the same economic activity).

From a legal stand point, the Third Party Personal Guarantee is perceived as a strong collateral because it has been explicitly recognized in the 1984 Sudanese transactions act. Another source of strength lies in the associated use of cheques, which is a repayment tool that is stipulated in article 179 of the Sudanese Criminal Law.

III. Legal Undertakings

Legal undertakings take several forms in the provision of micro credit, chief among them is:

- The legal undertaking provided by the borrower stating that he/she is not going to use the pledged good or asset until full payment of the loan.
- The provision of the legal undertaking as an additional collateral for obtaining a loan.

[28] The 1984 Sudanese transactions act stipulated in article 490 the surety for appearance of a person provisions.

- The legal undertaking may take another form which includes a declaration such as that provided by traders declaring that the goods in storage belong to the creditor until the full repayment of the loan. Such declarations are also further strengthened by insuring the goods with insurance companies.
- The affidavits.

However, these legal undertakings, as collateral, suffer from various constraints in their utilization as fully explained in the chapter on microfinance collateralization in Sudan. The experience of many microfinance providers, revealed that the legal undertaking is considered to be a weak collateral, not from a legal point of view, but from a practical one.

IV. Promissory Notes [29]

The legal terminology of a promissory note denotes a signed document promising payment of a sum of money, on demand or at a specific point in time, to another person, known as the beneficiary. Legally, the promissory note is governed by the country's civil law. Being civic in nature means that if the creditor is to take legal action against the borrower, then he must cover all legal expenses associated with case until the court makes its ruling. Despite its civic nature, the promissory note is considered a powerful guarantee, because it includes a written document containing the borrower's legal undertaking, the loan value, profits margins, as well as dates and schedule of repayments. However, in practice, promissory notes are problematic because they are not standardized and their stipulations differ from one creditor to another. This has proven to be very confusing to the micro-entrepreneurs who are limited in their knowledge of such matters.

V. Future Income as Collateral

From a legal point of view, expected future income pledged as collateral is one of the strongest forms of guarantees for repayment of loans. It derives its effectiveness from that fact that a third party supports it, which means that it is a legal form of surety. In this case the borrower or his surety works as an employee receiving specific wage or salary. Accordingly, the collateral is in the form of a letter of guarantee from the employer which implies that the employer acts as a surety or a guarantor since he is going to deduct the installment from the salary. Another example is the pension guarantee, in which the National Pensions Fund plays the role of the guarantor through its commitment to deduct the installment from the monthly pensions. A third example, which can illustrate this form of legally binding collateral is the deduction of future income that is expected to be realized from agricultural crops. However, this can only be applicable in the case of farmers working in agricultural schemes with management structure that can commit itself to deducting the loan against the forecasted income. It is clear that **the legal strength** of this type of collateral is linked to the existence of **third party (surety)** with the authority to commit to deducting the agreed amounts for loan repayment.

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[29] Insurance contracts in Islamic jurisprudence and law- D.Youssef Abdel Fattah - page 148.

CHAPTER 4

CONCLUSIONS AND RECOMMENDATIONS

The attempt to analyze Collaterals/Collateral substitutes and Credit Guarantee Schemes (CGSs) is a complex undertaking. Normally, practitioners delve into the details of technical related matters and in doing so, may run the risk of loosing sight of the overarching goals sought from studying the matter at hand. To avoid doing so, it is pertinent to start by re-iterating the major objectives underlying the recommendations for future action on the issue of collaterals/guarantees in micro-lending. These are as follows:

→ To expand outreach of credit and other financial services to a wider client base from the economically active poor in urban and rural areas of Sudan
→ To diversify services available to MFIs and borrowers
→ To provide practical incentives to Formal Financial Institutions (Banks) to embark aggressively on MF services, whether directly, or through establishing commercially viable institutional alliances

In addition, it should also be remembered that one of the core strengths of microfinance (MF) is being informal enough to quickly cater to the changes in the local community needs and social fabric/practices, especially with regards to collaterals. It is well known that the collateral substitutes widely known now had been initiated by individuals or MFIs (e.g. Solidarity Group guarantee in Grameen) to circumvent the fact that MF targeted clients lack adequate banking collaterals by definition. Therefore, whatever the efforts made to standardize or enforce collateral acquisition and disposal practices, the room for innovations, especially regarding collateral substitutes should be left and not interfered with.

Some of the terminologies used in the study may be clarified as follows:

- Microfinance Institutions (MFIs) are those providing their financial services directly to the targeted groups.
- Guarantee Institutions are those providing guarantee services to the MFIs.
- A Loan: refers to the financing being offered in line with one of the modes of Islamic Financing in Northern Sudan and the financing provided on conventional terms in Southern Sudan. As the recommendations, emanating from the study apply to all the country, we expect implementation in Southern Sudan of those appropriate to the banking system in place there.

The chapter will be classified into four sections; the first section will summarize the major findings from the field work undertaken in Northern Sudan; the second section outlines the guiding or underlying principles for the recommendations emanating from the study, the third section will list specific future recommendations; finally the fourth section will outline the major action areas with their proposed time frame for accomplishment.

I. Major Findings from the Field

This section will capture the major findings emanating from the field study and interviews with MFIs (both formal and informal).[30]

Bankers perception about MF:
Many bankers lack the necessary enthusiasm towards expanded engagement in microfinance activities. Most of them do not strictly apply the CBS directive of allocating 12 percent of their loan portfolio to

[30] A detailed exposition of the findings of the field survey is to be found in chapter 2 of the study.

micro-credit. Some believe that providing loans to the poor is a "social" service which is beyond their mandate and should be handled by Government organizations or charity bodies. This could be attributed mainly to their limited awareness of the potential of microfinance as a lucrative business and their limited exposure to local and international success stories.

Harsh conditions for personal guarantor:

The ***Third Party Personal Guarantee*** (TPPG) is widely used by banks and some other microcredit providers to secure loans not exceeding SDG 10,000 where the guarantor is required to issue post-dated cheque/s in addition to those issued by the borrower for repayment. For each cheque issued by the borrower, a parallel one is required from the guarantor. The number of cheques required is a function of the number of installments, which in turn is determined by the nature of the transaction e.g. in financing agricultural activities, payment is made by one cheque after harvest. In all different cases of TPPG, it is a condition that both borrower and guarantor must have a current, deposit or savings account with the concerned bank. This practice in itself is considered as an "entry barrier" to many economically active poor, which on the other side is translated into a challenge to service outreach.

Limited diversification of collaterals used by banks:

The range of collaterals used by banks in micro lending is limited. The focus of all banks visited has been on the TPPG for small loans not exceeding SDG 10,000. A major problem stated by all banks visited is that of getting hold of the borrower or guarantor, in case of default and enforcement of claims in TPPG secured loans.

Lack of proper client follow-up:

Visiting clients in their business places, before and after loans' disbursement, is rare because there are only one or two investment officers in each bank branch who are expected to cover both microfinance and commercial lending. In fact, the staff structure of bank branches is not appropriate for delivery of microfinance services which is a labor-intensive process. Successful delivery of microfinance services requires banks to operate near the community and depends on close monitoring and personal knowledge of clients and their businesses. The general staff structure is that, on average, there are 10 officers doing office work only for each investment officer. In microfinance, this situation should be reversed.

Lack of recognized best practice in micro-lending procedures:

The common feature among banks is that they apply similar lending procedures that mainly depend on office work and formal documentation rather than fieldwork. All banks are actually applying microfinance lending in a manner similar to commercial traditional lending. The focus of a bank branch is on the collateral, the character of the borrower, and the formal documents. The viability of the business comes second or third. Even the feasibility study done for the investment to be financed does not include a market study and does not reflect either monthly cash flows of the business or cash flows of the loan applicant in general. It does not determine whether the monthly cash flows are regular or irregular, in order to design the repayment schedules accordingly.

Current status of Guarantee Funds in Sudan:

The field survey revealed that there are about ten credit guarantee schemes in operation within the banks surveyed. Most of these funds have been recently established. The funds used in these schemes have been donated by government institutions, private companies, International Non-Governmental Organizations (INGOs), regional multi-governmental companies, and international donor organizations. All guarantee funds are managed by the Savings and Social Development Bank (SSDB) as government and donor agencies have entrusted the bank with the task of lending to their targeted beneficiaries by virtue of its mandate.

Salient Features of Sudanese CGF:

- Agreements governing these guarantee funds are more or less similar, these being: (i) the bank provides finance equivalent to 150 percent of the guarantee fund; (ii) The donating agency always nominates borrowers to be covered by the guarantee fund; (iii) in addition to the security of the guarantee fund, the bank requires targeted borrowers to issue postdated cheques equal to the number of loan installments; (iv) in some cases, a third party personal guarantor acceptable to the bank, is still required in spite of the presence of the guarantee fund.
- Most of the guarantee funds have shown sub-optimal performance. The experience has shown that when the funds are totally provided by a government body (e.g. localities), performance is very poor as the funds are perceived as a gift/grant. The poor performance is also attributed to the lack of clear and detailed lending policies, in addition to inexperienced staff, that have contributed to low repayment rates (ranging between 10 to 70 percent at best). On the other hand, the performance of funds provided by international organizations (e.g. Islamic Relief Worldwide-IRW) and agencies with development orientation (e.g. FAR and GEF for financing solar energy appliances), is much better than those provided by government and political institutions (Khartoum State and the Farmers' Union Funds). This superior performance is most likely the result of the appreciable amount of training of potential clients by these institutions in addition to their close monitoring and follow-up of borrowers.
- Procedures prior to loan disbursement, which involve clients' assessment/selection and assessment of the investments for which the finance is requested, are performed by the institution providing the guarantee fund. This has precluded proper borrowers' evaluation and loan analysis which should have been the responsibility of the bank undertaking the financing. The guarantor could assist in this process but after obtaining evidence related to efficient performance of the MFI's (bank's) loan portfolio and management practices.
- Most guarantee funds do not generate income to meet administrative cost and losses against loan defaults. This is because funds are not deposited in time deposit accounts nor any other form of income generating instrument. Moreover, they do not earn any income from the guaranteed loans. This jeopardizes the sustainability of the funds (de-capitalization risk) as has happened with several of them. On the other hand, bank officials explained that had the fund been deposited in an income earning account, the value of loans issued against the guarantee fund would not have exceeded the amount of the guarantee fund (i.e.: less number of loans and maybe of smaller sizes).
- The guarantee fund's management agreements lack compensation criteria that clearly specify the conditions under which the financing institution would be eligible for compensation from the fund and the period after which the finance institution should be compensated.
- A striking feature, in most of the guarantee funds, is that the risk is fully borne by them. This has encouraged reliance on CG without sufficient and proper loan analysis, monitoring of borrowers, and application of effective delinquency management procedures after loan disbursement. Risk should have been shared between the finance institution and the provider of the credit guarantee fund so as to create incentive for both the financing and the guarantying institutions to perform in an efficient and effective manner and thereby reduce loan defaults to a minimum.

It is clear that unless the above identified mal practices of guarantee funds are favorably addressed, the newly established guarantee funds will be trapped in the high default dilemma, similar to the ones established earlier with little benefit to the MF sector.

II. Guiding Principles for Future Recommendations:

In addition to the major objectives outlined above, there are specific opportunities, and sometime challenges that should be kept in mind while considering how collaterals and guarantee schemes could play a catalyst role for MF service outreach. Below is a discussion of the major principles guiding the recommendations emanating from the study.

Best practice in the extension of microfinance services is a pre-requisite
In microfinance, collaterals on their own are not enough to guarantee loan recovery and avoid risks of default. The international and local experience has demonstrated that the best type of guarantee is a viable project, a good client and close follow-up. Hence any recommendations advocating the adoption of lenient collaterals as a form of extending outreach must be supported by the implementation of best practice in terms of loan analysis, loan product design, risk and delinquency management procedures, actions before and after loan disbursement, and close monitoring. To adopt such practices, banks interested in delivery of microfinance services should restructure their branches in an efficient manner and adopt mechanisms, which make them nearer to the targeted clients. Intensive training to the sales force will be crucial for ensuring proper assessment of projects' viability and client's credibility, in addition to close monitoring and follow-up.

Collateral Requirements and CGS should not be designed to last forever:
In a perfect MF market that is well developed, lenders (whether banks or non-banks) will be extending their services in compliance with best practices standards. Accordingly, they will be willing to take the credit risk of their clients and admit credit history as valid collateral. Ultimately, this will lead to the initiation and utilization of credit bureau services and MFIs employing credit scoring technology. In this environment, MFIs do not normally require collaterals beyond the capacity of targeted groups and will increasingly resort to using collateral substitutes as loan security. On the other hand, MFIs can access local and international CGS services providers and gradually decrease their dependence on the scheme after experiencing the actual MF best practice portfolio performance.

Therefore, we should always maintain the vision that collaterals and CGS should not dominate the market in the long run. Poor households should have access to micro loans without the need to extend a collateral; and CGS are services introduced to MFIs to entice them to work with MF clients but MFIs should gradually overtake the risk without continuing to depend on the guarantees offered by CGS

The Government's role in creating a supportive environment
One of the major principles underlying the recommendations is that the government's role is confined to creating a supportive legal and financial environment rather than being a service provider. Accordingly, it is expected that legislative and administrative constraints related to the adoption of more flexible collaterals needed to expand outreach will be addressed (e.g. land registration process and fees). Moreover, transparency of MFIs performance histories and services offered, as well as advocacy for change from grant culture to creating an economically viable sector are to be aggressively pursued.

The role to be played by the CBS MF unit & the MF Development Facility (to be established):
In addition to its traditional role as a regulatory body for the MF sector, the role of the CBS MF Unit is to act, in the short term, as the government's arm in developing the sector to expand outreach to the targeted community of economically active poor, especially in rural areas. To this end, the role of the Unit will be to design guidelines for suitable collateralization and guarantees and stand ready to promote capacity building in the form of both financial and technical assistance. Its role will also be in advocacy, and attracting international CGSs. In this respect, it should be noted that the development

role being currently undertaken by the Unit is one of a temporary nature as it is expected to gradually relinquish this role to the MF Development Facility which is planned to be established in the near future.

The challenge for the MF Unit will be to maintain a "healthy" distance from service providers, meaning that the involvement of the unit should be restricted to being a supporter and neither a direct manager of the CGS nor itself a service provider. One of the major roles for the CBS MF unit also is to promote best practices in service extension and client monitoring to MFIs, as well as to develop practical incentives to attract banks to serve this market niche. The specific recommendations outlined below will cover these issues.

III. Major Recommendations

This section provides the recommendations emanating from a careful study of the international and regional experiences and how they relate to the Sudanese experience and keeping in mind the objectives outlined in the beginning. In doing so, the recommendation give due consideration to the legal and administrative connotations of the measures being considered. The set of recommendations are divided in four parts, these being: (A) Design/Procedural Measures, (B) Expansion/Diversification in Non-Conventional Collaterals, (C) Institutional Measures, (D) Technical and Financial Assistance

A. Design/Procedural Measures

A.1. Risk Sharing by MFIs

Based on international experience, it is always recommended that the MFI share part of the credit risk, even if it acquires a "Credit Guarantee" service. In most cases where the MFI is not bearing part of the credit risk, officers will be more lenient in following-up their delinquent clients and may even spread the word among the clients that their loans are "secured", thereby leading to portfolio quality deterioration. The benefits of risk sharing have also been proven in the case of Sudan where the field survey indicated that among the best performing CGSs is the Solar Unit Fund which requires that the MFI co-share the credit risk with the guarantor.

The risk sharing factor will allow MFIs to practice risk management techniques and at later stages to gradually phase out the CGS whenever the credit risk in the portfolio *(PAR greater than 30 days)* is sustained at a level lower than the guarantee fee. As a matter of fact, risk sharing by MFIs is one of the most effective measurements that could be taken by a guarantor to ensure true interest and sincere efforts by the lender to recover non-performing loans.

Finally, there should be a link between the performance track of MFIs and the assistance they get in accessing CGS. MFIs that prove sustained solid performance should have a priority in accessing CGS and increasing their capital base to allow for service outreach.

A.2. Linking Borrowers to Credit Risk

Deposits collected from members of CBOs to be pledged as partial collateral for loans that the CBO clients' obtain is an effective tool in linking the end-borrower to credit risk. (e.g. the 40% provided by the Women Union to SSDB Gedarif as a collateral). The contribution of borrowers to the loan fund and the concomitant risk of loosing part of their funds in the case of default, motivates borrowers towards greater commitment to pay back and to observe sound lending/monitoring practices. This is a typical example of mixing "hot money" (savings) with "cold money" (lender's money). The depositor is keen not to loose his/her savings pledged as a guarantee against default.

However, the condition for successful expansion of micro lending using this type of collateral is the payment of a return on the funds saved by CBO members. Operationally, this means that savings of members of CBOs should be pooled and invested in a revenue generating vehicle at the same time as they are being blocked as deposit partial collateral for the loan portfolio. The return earned on the deposit could either be capitalized on the same fund or distributed to CBO members in proportion to their savings, or partially both. The important point here is the need to leverage the deposits in tandem with a sustained high quality loan portfolio.

A.3. Graduation to More MF Friendly modes of Financing

Experience has generally shown that MFIs are at the height of their exposure to risk in their first loan or transaction with clients. Accordingly, some MFIs, intentionally, limit their first loan amount and tenor to try-out the client before entrusting him/her with another loan of a bigger amount and a longer tenor. The same logic could be perfectly applied in Islamic MF. MFIs, generally, start with small loan amounts extended through "Murabaha" agreement entailing sales/ profits and coupled with a collateral/collateral substitute. With time and as the client proves credit worthiness and/or economically successful enterprising, the MFI could move to other modes of financing like Mudaraba and Musharaka, both of which are based on the risk/reward relationship.

In the conventional system, recognition of good clients is clear with MFIs giving credit worthy clients privileges related either to loan size or interest rates or grace periods or longer tenor or a combination of all four. A benchmark that is usually applied constitutes payback within seven days of due date throughout the loan duration (for two or three loans). When applicable, the client is awarded the new status and could even be recognized by a "Golden Membership Card", a "Bonus Insurance" or the like.

In Sudan where Islamic financing is practiced in the North, special consideration for clients with solid credit history who are increasing their repetitive loans should be in the form of graduation from one type of financial service that requires collateral (Murabaha) to another that entails risk sharing (Mudaraba and Musharaka). However, it is recommended that such graduation be done after careful consideration of the credit worthiness of clients.

Needless to say, these alternative modes of financing require that MFI officers acquire a specific and highly advanced set of skills related to business appraisal, cash flows, and accounting, as well as close field monitoring on the part of the MFI as a business partner and not as a creditor. Finally, access to non-financial business-related services is an important aspect in these schemes. <u>The graduation from Murabaha mode of financing to Musharaka and Mudaraba could be taken up as a directive in the microfinance policy issued by the CBS to be applied for trusted clients based on their credit history.</u>

<u>B. Expansion/Diversification in Non-Conventional Collaterals</u>

Both international experience and the limited experience of Sudan, mostly in informal financial lending, have shown that non-traditional collaterals are more in line with the needs and abilities of the targeted clients, i.e. the economically active poor who are not able to provide the stringent collaterals normally required by formal financial institutions. The application of such flexible collateral arrangements, as the main form of loan security, serves the purpose of expanding outreach of micro finance services. Yet, it is worth noting, that NOT ALL the forms of non-traditional collateral that have proved their success when adopted by CBOs are equally effective when adopted by formal financial institutions (mostly banks) in the provision of their microfinance services. In what follows, the main forms of collaterals to be recommended in the case of Sudan are provided with careful consideration being given to the conditions, both institutional and legal, under which each type is applicable.

B.1. Group Collateral

Group collateral (group solidarity) which was first introduced by Grameen Bank of Bangladesh has been adopted by most start-up MFIs as their main form of loan security. Loans are extended to individuals who are members of solidarity groups but each group is held responsible for member repayment. Under an individual lending contract, each borrower, if he defaults, has to fear the penalties the bank can impose. Under group lending s/he will additionally incur the wrath of other group members. If the group is formed from communities with a high degree of social connectedness, then this may constitute a powerful incentive device for repayment. Groups of 15-20 members can be formed by bank's field officers. This type of collateral is recommended for institutions starting their first engagement in microfinance operations[31] as it is strongly believed to greatly contribute to expansion of outreach. However, the Group Collateral methodology is considered to better serve the needs of CBOs, NGOs and BA's rather than the banking sector.

B.2. Blocked Savings:

Savings is strong collateral practiced by CBOs and grass roots organizations especially women groups. Saving is wide spread habit among low-income people and is practiced traditionally in different forms. Offering appropriate returns on savings by banks and making the service easily accessible to savers would serve two purposes. *Firstly,* it increases the amount of savings mobilized by banks, which is a cheap source of funds for lending capital. *Secondly,* savers who are at the same time borrowers would prefer to keep a good relation with the bank to benefit from the savings returns. However, in considering returns on savings in Islamic financial systems, we must bear in mind that Islam prohibits that money makes profits in and by itself; meaning that savings and deposits should not be marked-up by a pre-determined rate of interest to be paid to savers and depositors. The only solution is to treat savings in an economical manner. Accordingly, one option is to consider these savings as a "pool of funds" to be invested in a specific activity or sector "Mudaraba". Another option is for depositors to receive annual returns based on the contribution of their deposits in the investment portfolio of the bank. In this regard, savings accounts are treated similar to investment deposit accounts.

B.3. Chattel Mortgage

An advantage of this type of mortgage is that it leaves the asset in the custody of the borrower, allowing him/her to continue to benefit from it. However, the lender would still possess the ownership title. Chattel mortgage, in Sudan, is usually used in the hire purchase (lease-sale) loan contracts for financing vehicles, motorcycles, in addition to agricultural machinery.

Another type of Chattel mortgage recommended for use is the ***pledging of business equipment through an ownership document.*** This form of collateral could be used with old clients who own established well performing businesses and have good credit histories. The mortgage should cover existing equipment and that to be financed. However, Chattel mortgage, in general has some weaknesses. These include: (1) the rate of depreciation will vary according to the intensity of asset utilization; (2) asset valuation could be problematic due to arbitration; (3) foreclosure on and disposal of assets by the lender in case of default could take a long time and yield insufficient returns.

To mitigate such negative aspects, lenders should follow the following guidelines: (a) use the services of specialized (agreed-upon) offices for proper valuation of the assets pledged; (b) close monitoring and follow-up of clients will ensure first hand information about the development of the

[31] Microstart-UNDP

business; (c) loans should not greatly exceed the value of the asset at the end of the loan period; (d) Chattel mortgage should generally be used for short-term loans not exceeding one year; (e) a simple mortgage contract should be drawn out and registered, possibly, at the general attorney office or any relevant authority. Moreover, a medium term recommendation would be to amend the civil transaction act of 1984 to expand its coverage to include other types of movables not registered such as equipments and machinery which value is not less than SDG 5000.

The abovementioned comments, if addressed, could render the mortgage of non-registered movable assets strong collateral as it serves the purposes of both formal and informal institutions in the field. As such, it recognition would contribute greatly to the expansion of MF services in the country.

B.4. Mortgage of agricultural land and commercial real estate registered with Local Government Authorities:

Agricultural lands with ready or potential access to a permanent source of irrigation, as well as real estate assets registered at the localities and administrative units and have a significant market value and as such can be used as collaterals in rural and suburban areas. However, according to the Sudanese civil laws (Land Registration and Settlement Ordinance 1925 and civil transactions act 1984), mortgage of agricultural and urban lands can only be effective when registered with the federal lands registration authorities.

To be accepted as strong collateral the localities should have the legal right to register and accept mortgages of real estates, which are not registered with the federal land registration authority. The transfer of possession should be restricted and should only be considered legal when approved by the concerned authority at the locality level. Having said that, a note of caution is in order here: Before accepting such mortgages, the financing institutions should make sure that the real estate has a market value, and in possession of the owner in a continuous and un-interrupted manner for a reasonable time period without claims by others or any other threatening dispute.

In this respect, the CBS MF Unit/ MF Development Facility can play an important role by intervening with the relevant authorities (Ministry of Justice, Notary Public, …etc) to present the cases of MF clients who own assets that are either not registered or need a big sum of money to pay for the registration. In Egypt, the Social Fund for Development has led the effort to bring this case in front of decision makers and this resulted in decreasing the registration fees by the Notary Public Authority which is a division of the Ministry of Justice.

B.5. Pawning

The pawning of valuables (in the custody of the lender) is a strong collateral that is widely and successfully used by microfinance institutions. In Sudan it was first used by the Eastern Kordofan Rural Council during the fifties and sixties and by the Savings Bank in Wad Medani in the mid seventies. Examples of MFIs around the world that have had notable success with this type of collateral is the Self-Employed Women Association (SEWA) Bank in India and the Small Enterprise Credit Fund in Aden-Yemen. In using pawning as collateral, the valuables have to be valued carefully and fluctuations in market prices should be considered in the value of loans.

Pawning can also be used by CBOs against loans to their members as an alternative to or additional to savings. However, this type of collateral should not be considered as a primary resort, especially for grass-root organizations, primarily for safety reasons. In the case of banks, the definition of valuables should not be extended to include all types of items. Gold and jewelry are best suited to be pawned to banks.

B.6. Standardization of Legal Loan Documentation

One of the major findings of the field study of MFIs in Sudan was that the legal documentations required by banks in their microfinance dealings took different forms and wordings that itself was a source of confusion for the targeted clients (for details see chapter 5 on legal environment). It is, therefore, necessary that formal micro-finance institutions standardize their legal documents in the form of promissory notes, loan contracts, legal undertakings, and mortgage contracts.

C. Institutional Measures

C.1. Widen the use of Institutional Third Party Guarantee (ITPG) through CBOs/BAs (in cooperation with Formal Financial Institutions).

In general, Institutional Third Party Guarantees (ITPG), in which CBOs and BAs act as the third party guarantor, is a preferred model over personal guarantees. This is because it helps institutionalize the guarantee process while availing it to a wider client-base. Through this model, rural areas could be better served as they are usually lacking in salaried or financially solvent individuals who could act as third party personal guarantors. However, it must be noted that the sustainability of this service and its expansion will require that CBOs/BAs offering the guarantee service: (a) meet minimum performance criteria; and (b) price the guarantee service fairly and mark-up the loan transaction accordingly. Moreover, these guaranteeing CBOs and BAs will have to form alliances and/or access portfolio insurance services to hedge their risk exposure for the guaranteed persons, especially against force majeure and natural disasters.

It is logical to expect that the amounts collected by CBOs/ BAs will not be sufficient to guarantee the whole loan portfolio. The partial guarantee could range from 10% to 25% at most. Accordingly, the unions formed from CBOs/ BAs should have access to facilities that could augment the amounts collected as guarantee. Such facilities could include government owned and/or commercial banks as well as international and national credit guarantee schemes.

C. 2. Mutual Guarantee Schemes

Mutual Credit Guarantee Schemes (MGSs) are formed when a number of enterprises/entrepreneurs make payments to a cooperative or any other form of business associations (BAs), which will then be prepared to guarantee loans taken out by any of its members. The formation of such funds have several advantages among them are: (1) they facilitate access to credit especially by rural microfinance clients (farmers, artisans, and tradesmen) who can effectively be served through the community financial intermediaries; (2) Unlike government funded schemes, members guaranteed by an MGS develop a sense of ownership of the fund and so their attitudes are expected to be positive towards loan repayment, fund management and utilization.

According to lessons learned from international experiences, the most successful MGAs have the following features:

1. They were established by existing CBOs or business associations (BAs) that already share a common bond;
2. They are self-promoted which is important for the feeling of ownership among members. If the initiation came from a bank for example, members will perceive the scheme as a means through which the bank attempts to rid itself from the risk. In addition, banks are one of their counterparts; they must remain separate entities operating on equal footing with MGAs.
3. The most successful MGAs, at the grass-root level and in rural settlements, are those registered as non-profit entities, e.g. as cooperative societies.
4. The start-up capital is contributed by members, not by government, another local donor or an international donor. The MGA should always start by members' shares. It should be the result of

the strong will of beneficiaries reflecting a bottom-up approach. The role of the government should be in providing support in regulation, creation of a conductive operational environment, facilitation of access to technical support and limited financial support.

5. Management with developed technical capacity to analyze loan applications.
6. The MGS and banks share the risk equally or based on negotiated percentages.
7. Encourage CBOs/BAs to have stronger roles in other issues related to the interests of their members.

Formation of mutual credit guarantee schemes/associations within existing CBOs and BAs (like artisan cooperatives, farmers' cooperatives, and other producer cooperatives or even based on geographical span of services) should be supported technically, financially and morally. Due to limited funds, which can be raised by these institutions from their members to establish a fund, government and donors can match the start-up capitals contributed by members. The government and donors should set eligibility criteria for this support. The criteria should be based on certain requirements and minimum standards for performance in credit operations to be achieved.

This recommendation should be studied carefully in terms of whether it should be a separate association affiliated to the promoting association or merely a fund within the promoting association, the appropriate legal entity, regulations governing operations etc. Before providing support, the existing CBOs/BAs should be assessed carefully and then a limited number of interested CBOs/BAs of good potential could be selected and trained to start the support program on a pilot-basis for two years, after which the program could be evaluated.

The role of the government is important in ensuring the success of such schemes. The state can create the legal and regulatory environment conducive to the growth of member owned schemes, provide a limited matching capital, and can help facilitate access to training and capacity building.

C. 3. Lending through Community Based Organizations (CBOs) and Business Associations (BAs)

MFI lending to CBOs to re-lend to members is one of the feasible means by which rural remote communities can access savings and credit services. In addition to the legal entity of the CBO, blocked savings or mutual guarantee funds can be utilized by banks as loan security. CBOs should augment the savings of their members by using promissory bills, pledging of animals, personal household belongings, in addition to pawning of valuables against loans extended to these members. These additional collaterals are necessary in reflecting borrowers' commitment because the blocked savings is not expected to be more than partial collateral. Banks should ensure that CBOs are applying these collaterals in addition to the appropriate delinquency management tools at the CBO level.

Furthermore, lending to CBOs should be made when the CBO meets a set of agreed basic operational requirements and achieve minimum acceptable standards of performance. The standard of performance should be judged by indicators like:

- Solid legal identity and proper Governance structure
- Adequate organizational structure with job descriptions
- The quality of financial management;
- Application of the administrative rules, credit by laws, and delinquency management procedures; meetings of CBO committee and groups etc;
- Amount of savings mobilized;
- The quality of the CBO lending portfolio judged by recovery rates, percentage of arrears, percentage of portfolio at risk and loan loss provision adequacy.

The Bank of Sudan microfinance unit could play a vital role of agreeing to and setting these requirements and standards of performance in line with the above suggestions. The requirements and standards of performance should be checked by banks in processing CBO borrowing applications.

Moreover**,** community financial intermediaries and BAs established by micro and small entrepreneurs in the different sectors that are interested in performing a financial intermediation role should be encouraged to establish mutual guarantee funds (MGF) based on members' contributions.

C.4. Increasing the Efficiency of Local Credit Guarantee Services:

CGS is considered a service that is offered to MFIs to guarantee whole or part of their portfolio credit risk. This means that the MFIs have to treat this service with a "procurement" mentality and they should be able to access information about existing CGS locally, regionally, and internationally, compare their fees and determine the best vendor. On the other hand it will be necessary to reform the management of existing Credit Guarantee schemes to increase their efficiency and expand their outreach. The section on the current status of CGS in Sudan clearly highlights the areas of weakness which will need to be addressed if this service is to fulfill its role. Some of the recommendations in this regard have been addressed in earlier stated procedural measures, namely: ***Risk sharing by MFIs***. Moreover, the relevance of underlying principles cannot be over-emphasized in relation to CGS. These being:

(i) Institutions providing the guaranteed loans are adopting best practice in MF delivery;
(ii) the temporary nature of such guarantee schemes;
(iii) the role of the government as a supporter and facilitator rather than a service provider

In addition, specific recommendations pertaining to correcting current management malpractices include the following:

Limiting Guarantor Interference in Client Selection:

The most important factors contributing to the success of CGS are: (a) non-intervention by the guarantor in the MFI/bank's procedures and decisions so that client selection is left to the MFI based on assessment of client creditworthiness, and (b) cooperation between the lender and guarantor is based on a well-drafted comprehensive agreement specifically determining the role and responsibilities of each party and stipulating the following:

- remuneration entitlements,
- documentation and evidence requirements,
- time frame for decision making and re-imbursement by the guarantor,
- the process by which the guarantor will ensure that the lender is adopting best practices in operations, and that the lender has performed diligently in attempting to recover the delinquent debt. This type of assurance should be provided by a third "independent" party, normally a rating institution[32].

Ensuring Cost Coverage:

Dependence on government and/or donator funds, whether national or international, is unsustainable and limits outreach. Accordingly, it will be important for the guarantee funds to generate income to cover their administrative expenses, pay bank claims, in addition to maintaining the fund's value and capitalizing it. This should be done by depositing funds in time deposit accounts or investing in other appropriate income generating vehicles. In conjunction, a reasonable fee should be charged on guaranteed loans (usually ranging from 1% to 2% per year).

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www.cgap.orgFor details on rating agencies [32]

These recommendations are expected to contribute greatly to the efficient functioning of the existing CGSs and thereby facilitate the development and promotion of a healthy microfinance market. To greater enable these funds to achieve their objectives and to secure their mandate, the Central Bank of Sudan (CBS) MF Unit should look into setting management guidelines for credit guarantee funds/schemes that conform to international standards and best practice, adapted to local conditions.

C.5. Attracting International Credit Guarantee Services (CGSs)

International CGS are increasingly and successfully offering their services at the local country level. In fact, the microfinance market in the Middle East has been witnessing entrance of CGS like Grameen-Abdel Latif Al-Jamil fund, PlaNet Finance-Surety Fund, and others. Some MFIs in Egypt and Jordan have already accessed either direct loans or guarantee schemes for obtaining lines of credit from local banks through these institutions/funds. The competitive environment created by entry of International CGS into local markets, can be a positive development particularly given the recommended strategic orientation of temporary intervention by such guarantee schemes. Given this proviso, entry of CGS should be encouraged because not only will they expand outreach of hesitant MFIs, they will also bring to the market their ability to access advanced re-insurance facilities as well as its advanced management/reporting capabilities, and above all its financial soundness (credit worthiness) that is assured by international financial compliance and reporting standards.

In order to act quickly and comply with best practices standards, it is encouraged during the start-up phase of the industry to facilitate the entry and work of specialized CGS to Sudan, taking into consideration the political and economic situation and accordingly current limitations. This approach will tap on the know-how of existing international organizations to build the capacity of the locally initiated/operated CGS while paving the way for partnerships with Sudanese Financial Institutions. A priority requirement for International CGS to start offering services in Sudan will necessarily need to be given to ensuring that local MFIs meet the minimum requirements of such Guarantee Agencies as regards portfolio at risk. Analysis of the requirements of each will need to be conducted to determine the most suitable facilities to operate in Sudan. The expected requirement will be to have access to market information as well as obtain assurance about profit collection and transfer outside Sudan.

The CBS MF Unit/MF Development Facility will have to lead the effort of awareness among local banks and microfinance institutions about the existence of specialized CGS, how they operate and how to contact them. In addition the CBS should facilitate market entry of specialized CGS by ensuring a supportive regulatory framework and minimum bureaucratic entry procedures. The MF Unit/ Development Facility can also facilitate the access of Sudanese MFIs to international CG services through networking and communications that will encourage the establishment of strategic partnerships between them. In that regard, the CBS MF Unit/ Development Facility could start a dialogue with MF international stakeholders[33]. It must be noted, however, that the role of the unit should be to facilitate and not to take a negotiating position in such agreements. Strategically, the MFIs should be able to undertake strategic partnership deals with minimal assistance in order to survive outside an overly supportive environment.

C. 6. Expanding the use and practice of Insurance Services

Insurance provides different products that would protect lenders and borrowers from various risks. Although insurance is not an alternative for tangible collaterals yet it reduces risk of default due to unanticipated factors that are beyond the control of the microfinance client. The potential of insurance, as a risk transfer mechanism in microfinance operations, has not been fully realized in Sudan – neither by borrowers nor by MFIs. Insurance of assets and goods of small and microenterprises has been very

[33] The World Bank, IFC, CGAP, Agence Francaise de Development (AFD), Kfw, UNCDF

limited, particularly for enterprises operating in rural areas. It is, therefore, strongly recommended that:

(a) microfinance service providers, microfinance clients and insurance companies must investigate access to credit insurance services. This should be done while keeping in mind two things: (i) Credit insurance, intended to cover, partially or wholly, default in payments by the borrower is a recognized method of risk transfer under certain circumstances to be incorporated in insurance products on offer; (ii) Insurance services are services targeting the end-user "ultimate borrower", as well as the MFIs in some cases. Therefore, it should always be treated as a service that has a premium to be paid, and should always be ratified in terms of its compliance with the Islamic Sharia and practices when practiced in Northern Sudan.

(b) Insurance Companies should promote their insurance products especially among rural communities, and in cooperation with CBOs the CBS MF unit, and international insurance providers. In addition insurance companies should bring their services closer to and easily accessible to microfinance clients. Insurance products that target the traditional rain-fed agricultural sector and insure against possible failure of crops due to natural hazards and pests, should be considered as this would particularly benefit small scale farmers. Such agriculture insurance is to be offered as an expansion of the service already in place for insuring livestock. These two services will need to be more aggressively advocated in branches of insurance companies closer to the rural areas. Moreover, existing mortgage protection plans provided, in case of death or disability in the procurement of vehicles or real estate (mainly houses), could be expanded to cover assets procured by small and micro-entrepreneurs for their business and financed by MFIs.

(c) the CBS MF unit/ MF Development Facility could also investigate available insurance schemes for MFIs[34], and facilitate discussion with local insurance companies in Sudan. This should be the first step on the road of expanding insurance services to MFIs and is a practical arrangement since international insurers will normally need a local insurance company to do the "fronting"[35] for the policy.

D. Technical and Financial Assistance – Government and Non-Government

D.1. Financial Support in the first years of operation

Allocate matching funds by Government (CBS) and Donors to leverage MGF provided by CBO/BA

The recommendation for the establishment of MGFs will be constrained by the limited funds that could be mobilized from members. It is, therefore, recommended that additional funds be raised from the government and donors to match the start up MGF capital raised from CBO/BA members. The Government and donors should allocate financial support based on minimum eligibility requirements and standards of performance dictated in the recommendation pertaining to MGF. The financial support should be started on piloting basis with few CBOs and BAs and after a thorough situational assessment of the existing institutions. During the pilot phase, the criteria of funds allocation and the performance of the supported MFIs should be closely monitored and accordingly refined before expanding fund allocation across the board.

[34] Through investigating CGAP, French Development Agency, Kfw, and specialized funds like Grameen Foundation USA

[35] Representation, follow-up and claims' handling

D.2. Technical Assistance Requirements

In offering micro-credit services, reliance on collateral alone – be it conventional or non-conventional - will not secure loan repayment. Proper clients' assessment, appropriate loan analysis, design of suitable loan products that meets clients needs, tailored delinquency management procedures, in addition to efficient loan and client monitoring systems are necessary to achieve high levels of performance. Currently, the branches of the banks surveyed for the purposes of this study, are not adapted to deliver microfinance services. Adaptation of branches to deliver and manage microfinance operations should involve the following aspects:

- Preparation of branches business plans (Strategic plan, branches assessments, market assessments, operation plans, and financial plans). Conducting markets assessment is essential for the business plans because most branches have not explored the microfinance market in their respective areas
- Branch restructuring to reallocate staff between field and office tasks;
- Staff training,
- Lending policies;
- Design of staff incentive schemes;
- Loan product design and the introduction of more loan products to meet clients needs;
- Design and instill loan analysis, approval systems, and delinquency management systems;
- Procure/Design management information and reporting systems; etc.

The CBS MF Unit has initiated an intensive training course for banks selected to participate in the microfinance project. Not only will there be a need to assess the outcome of this initial training but also there is a need to ensure that these participating banks have identified and designed a plan for what needs to be done and based on what has been learnt.

E. Public Awareness

It is strongly recommended that great utilization be made of the media (in its different forms television, radio and newspapers), in disseminating information on microfinance products being offered to small and micro-entrepreneurs and how to access such services. Likewise, there is a need to disseminate information to MFIs where the message through the media will focus on international best practices and how to expand outreach particularly to the rural areas.

IV. ACTION PLAN & TIME FRAME FOR IMPLEMENTATION

The following table illustrates the above mentioned recommendations in relation to the responsible and/or implementing party, perceived major requirements for success, and expected time frame. These are based on the technical team's view and hence, could be amended to comply with legislative and/or procedural priorities.

***EXPECTED TIME FRAME: S=LESS THAN 1 YEAR, M=1 TO 2 YEARS, L=3 TO 5 YEARS**

REQUIRED ACTION	RESPONSIBLE/IMPLEMENTING PARTY	MAJOR REQUIREMEMNTS FOR SUCCESS	EXPECTED* TIME FRAME
A. Design/Procedural Measures			
A1. Promote Risk Sharing by MFIs in credit guarantee schemes.	CBS MF Unit, Donors, and relevant Banks	• Introduction and dissemination of information and knowledge about CG mechanisms/services. • Autonomy of CGS management with risk sharing from MFIs..	S M
A2.Linking the end Borrowers to Credit Risk - using Deposits (savings) as collateral.	CBS MF Unit, CBOs/ BAs.	• Establishing the principle of paying a return on the funds saved especially funds blocked for collateral. • CBS Micro-credit policy to include group (CBOs/BAs) savings as acceptable collateral.	S S
A3. Graduation to More MF Friendly modes of Islamic Financing. In the South of Sudan, graduation is in the form of more favorable financing conditions.	BOS and microfinance providers.	• Directive in the microfinance policy issued by the CBS encouraging graduation to 'mudaraba' and 'musharaka' modes according to clients' solid credit history in light of best microfinance practices. • Buy-in (acceptance) from MFIs. • Directive in the microfinance. policy issued by BOSS to encourage graduation of credit worthy clients by offering them privileges related either to loan size or interest rates or grace periods or longer tenor or a combination of all four.	S M S

B. Expansion/Diversification in Non-Conventional Collaterals			
REQUIRED ACTION	**RESPONSIBLE/IMPLEMENTING PARTY**	**MAJOR REQUIREMEMNTS FOR SUCCESS**	**EXPECTED TIME FRAME**
B.1. Direct microfinance providers (banks) to reduce dependency on third party personal guarantees by investigating and adopting different types of non-conventional collaterals.	CBS, Microfinance providers.	• CBS microfinance policy to include directives for the exploration and adoption of non-conventional collateral as a substitute to third party personal guarantees. • Collaboration of MFIs and willingness to explore new types of collaterals. • CBS disseminate and support good practices in non-conventional collateral and exchange of experiences among MF providers. • CBS to direct banks to restructure so as to ensure more efficient utilization of resources in line with the particular requirements of the delivery of microfinance services.	S S S S
B2. Acceptance of agricultural land and commercial real estate registered with the Local Government Authorities as collateral.	• Relevant Federal Government authorities. • The local government authority. • CBS in consultation with experienced MF providers.	• Strengthen the local land registry system. • Transfer of ownership title should be based on the local registry. • CBS include mortgage of locally registered land as acceptable collateral in its credit policy.	S M L
B3. Standardization of Legal Loan Documentation. (Promissory notes, loan contracts, legal undertakings etc).	CBS in collaboration with the Sudanese Banks Association, and MF providers.	Streamlining, unification and dissemination of standardized documents.	S

C. Institutional Measures			
REQUIRED ACTION	**RESPONSIBLE/IMPLEMENTING PARTY**	**MAJOR REQUIREMEMNTS FOR SUCCESS**	**EXPECTED* TIME FRAME**
C1. Widen the use of Institutional Third Party Guarantee (ITPG).	CBSMF Unit in cooperation with CBOS/BAs, and MFIs.	Establishment of eligibility requirements at the client and institutional (CBOs/BAs) levels.	S
C 2. Promote Establishment of Mutual Guarantee Schemes.	CBS MF Unit, other government institutions and donors in cooperation CBOs/ BAs	• Establishment of eligibility criteria for obtaining donor and/or government financial support. • Willingness and ability of CBO/ BAs' members to contribute to the start-up capital of the MG scheme. • Government to provide support in regulation, creation of a conductive operational environment, and facilitation of access to technical support. • Government and donors are willing to match the start-up capitals contributed by CBO/BA members	S M M M to L
C 3. Promote lending by Formal Financial Institutions (FFIs) through Community Based Organizations (CBOs) and Business Associations (BAs)	CBS MF Unit in cooperation with the MF stakeholders (MFIs, CBOs/BAs.)	CBOs meet a set of agreed-upon basic operational requirements and achieve minimum acceptable standards of performance.	S to M

REQUIRED ACTION	RESPONSIBLE/IMPLEMENTING PARTY	MAJOR REQUIREMEMNTS FOR SUCCESS	EXPECTED* TIME FRAME
C4. Increasing the Efficiency of Local Credit Guarantee Services.	CBS MF Unit and other government institutions (as supporters/facilitators and not as service providers), and donors.	• Limiting Guarantor Interference in Client Selection. • Ensuring Cost Coverage. • Setting other best practice management guidelines adapted to local conditions	S M M
C5. Attracting International Credit Guarantee Services (CGSs)	CBS MF Unit in cooperation with MFIs and in consultation with International Credit Guarantee service providers.	• MFIs able to meet minimum performance requirements. • Explore international CG service providers and their requirements. • Create links with international CG providers. • Facilitate market entry by ensuring supportive regulatory environment.	M M M M
C 6. Expanding the use and practice of Insurance Services	CBS MF Unit/MFDF, insurance companies, and MF providers.	• Increase awareness of available micro insurance products among microfinance providers and clients. • Avail access to microfinance clients especially in rural areas.	M M

D. Financial and Technical Assistance – Government and Non-Government			
REQUIRED ACTION	**RESPONSIBLE/IMPLEMENTING PARTY**	**MAJOR REQUIREMEMNTS FOR SUCCESS**	**EXPECTED* TIME FRAME**
D1. BOS to provide financial support to augment the financial resources of MGFs.	BOS, other government institutions, Donors.	Additional funds raised by government and donors to match the start up MGF capital raised from CBO/BA members	M
D2. Support Technical Assistance to MFIs.	BOS MF Unit, Sudanese Banks associations, donor community.	• Qualifying MFIs have identified and designed satisfactory business plans • BOS MF Unit to evaluate its recent experience in support of training and accordingly support further programs. • Further technical support should be on cost sharing basis with participating MFIs.	S S S
E. Increase Public Awareness			
Greater utilization of media coverage in its different forms.	BOS MF Unit, media institutions and the donor community.	• Provision of adequate funding for media campaign. • Provision of needed media information and studies. • Provision of adequate media space.	S S S

Annex No (1)

Table: Current Status of Guarantee Funds										
Fund owner	**Date Established**	**Fund Value**	**Cumulative # of loans**	**Volume of Lending**	**Loans at risk**		**Portfolio at risk**		**Sums paid to recover defaults**	**% of loss**
					No	**%**	**Value**	**%***		
Solar units fund	2003	700,000	500	1,050,000	30	6%	29,735	4%	26,761	4%
Khartoum State productive families	2006	4,200,000	4,532	6,861,260	2,257	50%	3,443,327	82%		
Farmers union	2006	952,843	3,150	1,830,000	1,650	52%	800,882	84%	900,882	95%
Women Union	2006	500,000	288	750,000	200	69%	8,500	2%		
Gandato Agricultural Scheme	2006	550,000	245	800,000	-	0%		0%		
Islamic relief Organization	2006	100,000	95	135,000	3	3%	4,050	4%		
Arab Authority for Ag. Dev. & Investment	2007	156,000	170	181,500		0%	-	0%		
Ministry of Social affairs Kassala State	2006	384,000	430	428,389	360	84%	350,538	91%		
Ministry of Social Affairs Northern State	2006	300,000	246	450,000	55	22%	14,820	5%		
Shendi Development Authority	2007	500,000	-	750,000	-		-	0%		
Total		8,342,843	9,656	13,236,149	4,555	47%	4,651,852.00	56%		

* Percentage of total fund

Annex No (2)

Institution/Organization Surveyed during the Field Survey conducted by Unicons' Study Team

No	Institution/Organization
1	Eltawarig charity organization
2	General Investment Administration, ICDB H.Q.
3	Shaikan Insurance Co., Elobied
4	Savings and Social Development Bank, H.Q.
5	Graduates' Employment Fund, Khartoum 2
6	Social Development Foundation (SDF)
7	3 Group members (residential quarters)
8	Umbrella of Women Savings and Credit Associations, Gedarif
9	Network of Women Associations/CBOs (Ma'an)
10	Savings and Social Development Bank, Gedarif branch
11	Cooperative Society for Food and Beverages Sellers, Souk-Shaabi , Khartoum
12	Neilin Bank, Hilat Kuku Branch
13	Investment Section, Nilein Bank (H.Q)
14	Union of the Disabled Persons, Gedarif
15	Women Training and Promotion Society (WOTAP), Mayo, Khartoum
16	Community Development Society, Darassalam
17	SSDB, Elobied
18	Sandug Committee, Kadrouka village, North Kordofan
19	ABS Gedarif branch
20	Islamic Relief Organization, Elobied
21	Eltagwa savings and credit association (cooperative society)
22	Cooperative Society for Food and Beverages Sellers, Haj Yousif , Khartoum North
23	Badr-Elkubra savings and credit association (cooperative society)
24	Farmer's Commercial Bank, H.Q.
25	Microfinance Unit, ICDB
26	ICDB, Elobied
27	ABS, Jebel-Aulia branch
28	ABS, Elobied
29	Elziraia'a CBO, Elobied
30	Women Development Associations Network
31	Sudanese Association for Humanitarian Aid, Alsalama
32	ADRA, H.Q.
33	Sudanese Development Association, Khartoum 2
34	Oxfam GB, Mogran, Khartoum
35	Islamic Cooperative Development Bank, Gedarif
36	Women Development Association – Gedarif
37	Eltadamon savings and credit association (cooperative society)

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