



## Practical Aspects of Establishing a Belarusian Guarantee Fund

### Summary

This paper deals with several practical questions that arise during the conceptual stages of establishing a Belarusian Guarantee Fund for loans to small enterprises (SEs). The first question to be answered is what amount of guarantee capital will be needed to effectively operate the fund. We analyzed the specific Belarusian conditions and found the approximate amount of guarantee capital needed to be about USD 5.8 m, which means that the amount of funding required from the government will be about USD 2.8 m. Next, we discussed the best juridical form within which the guarantee fund should be established and operated. Despite the fact that in an economical sense the organization is obviously a non-commercial one, the legal form of a commercial organization should also be permissible. We reviewed the pros and cons of various concrete juridical forms and came to the conclusion that the Guarantee Fund should be created as a commercial organization. Among the many types of commercial organizations possible we found two acceptable ones: closed joint stock companies and limited liability companies. We then investigated the question of whether the Belarusian Fund for Financial Support of Entrepreneurs should be reorganized with the Guarantee Fund. We looked at its statutory norms and its economic performance and then concluded that the Guarantee Fund should be an independent organization without any connection to the BFFSE. Finally we looked at the new Guarantee Fund from the point of view of the banks, and reviewed the applicable banking legislation in order to determine those norms that could present obstacles to the guarantee fund's development. We suggest some amendments to the legislation such as permitting loans to be granted in cash form, eliminating obstacles to legal entities when granting guarantees, and abolishing the reserve requirements for all deposits placed in banks by the Guarantee Fund.

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## 1. Introduction

Founding a Belarusian Guarantee Fund (GF) is one of the priority tasks in the sphere of small enterprise (SE) development in 2005. It complies with the main directions for SE development anticipated in the "Concept of state support and development of SEs for the years 2002 to 2005". At the current developmental stage there are still many questions to be raised and practical issues to be decided, which could considerably influence the effective operation of the GF.

This paper is structured as follows: In Section 2 we analyze the factors that determine the volume of the guarantees to be granted. Based on this analysis we try to assess the amount of the initial guarantee capital needed to meet Belarusian conditions. In Section 3 we consider the pros and cons of different legal forms for the GF. In Section 4 we consider whether the Belarusian Fund for Financial Support of Entrepreneurs (BFFSE) should be integrated with the new GF. In Section 5 we focus on the banking side and look at legislative measures that could make the GF operations more attractive to banks, which is at the core of creating mechanisms for consolidated guarantees.

## 2. How much capital does the Guarantee Fund need to function properly?

The guarantee capital level must meet the following criteria: the guarantee capital should be sufficient to achieve the goals of SE development and improving SE access to capital on the one hand, while avoiding investment of excessive public resources on the other. In other words, a compromise is needed between the government's contribution – limited for lack of financial resources - and its leading role in the GF's equity.

Improving the access of SEs to capital through the mechanism of consolidated guarantees should not imply that all obstacles experienced by SEs when applying for capital should be eliminated. Indeed, establishing a GF should not even suggest the intention to solve all these problems. According to SE polls there are a number of obstacles when applying for a loan (see Table 1).

**Table 1. Estimation of problems by SEs when applying for borrowing**

Factor	Assessment
High interest rate	4.08
No permissible delay for interest payments	3.43
Absence/lack of collateral	3.38
Paper work complexity	3.14
Length of time required for considering an application	3.03
Unclear criteria for granting loans	2.96
Corruption	2.68

*Source: Daneyko, Pelipas, Rakova "Belarusian business: stance, tendencies and perspectives".*

Note. 5 is the highest rating, 1 the lowest one.

The role of the GF is limited to granting guarantees to those SEs that would like to use bank loans, but cannot obtain them because they lack the collateral required by banks. This definition includes not only those SEs that applied to banks but did not obtain loans because they lacked collateral, but also - in broader sense - all those SEs, which desire loans, but never bothered to apply for the same reason. It is very difficult to assess the demand by both groups because of a lack of statistical data<sup>1</sup>. This fact makes it difficult to numerically express the objectives for establishing a GF. To solve this problem we expressed the objective as an increase in the flow of new loans granted – in 2004, which amounted to BYR 670 bn<sup>2</sup>. For the following calculations we considered the

<sup>1</sup> Potentially the first group can be estimated by aggregated data available to the banks, but banks do not report this kind of statistic. The second group could be assessed only through sociological polls.

<sup>2</sup> We assume that the earliest realistic date for the starting the new GF activity will be 2006. But since we only have data for the year 2004, we base our estimations on that year.

absolute value of this increase as BYR 250 bn<sup>3</sup> for the year 2006 as compared to 2005. But during the last stage of estimating the guarantee capital needed for achieving this goal we should consider not the flow, but the amount of outstanding loans granted under GF guarantees. In other words, based on the flow increase figure (BYR 250 bn) we must investigate what additional amount of outstanding loans it would generate, since the level of the guarantee capital is tied to it.

In a general sense the relation between the loan stock and the flow will be determined by the following three factors: the monthly growth rate of the newly granted loans flow, the credit period, and the repayment scheme. To clarify these parameters we made the following assumptions in our model.

**Assumption 1.** We assumed the amount of the guarantee capital for the first year of activity connected with the increase in the annual flow of loans granted, i.e. BYR 250 bn. Then, we assumed the monthly growth rate for the new loans flow to be one twelfth of the annual amount (BYR 20.8 bn=250/12) multiplied by a seasonal correction coefficient. In this manner we obtained the figures in the first column (new loans flow) of Table 2.

**Assumption 2.** Since banking statistics do not treat SEs as a separate sector, there is no exact data about the average credit period for SEs. To overcome this problem we searched for the bank customer group in which SEs are most significantly represented, and found it to be trade and catering. During the first half of 2004 43.5% of all SEs dealt with this activity. Thus we assumed the loan granting and repayment behavior of this sector to be representative for all SEs. In this sector the granting of short-term loans and the volume of outstanding short-term loans represent about 98.5% of the total loan portfolio. An analysis of the short-term loan dynamics showed that the average credit period is about three months. Hence, we assumed the average credit period to be three months.

**Assumption 3.** We assumed that principle will be repaid in equal installments throughout the term of the loan, beginning with the month following the granting of the loan. This assumption holds reasonably true for most actual credit contracts having a rather short term.

Assumptions 2 and 3 allow us to calculate the data in the second column (repayment flow), which is dependent on the new loans granted flow (see Table 2). The third column (net flow) represents the difference between columns 1 and 2.

We can now proceed to calculating the loan volumes. The outstanding loan amounts (in the fourth column) are given for the first day of each month. The current value is equal to the value of the loan volume of the previous month plus the net flow of the previous month. The procedure of granting loans under GF's guarantees defines the next steps. The conceptual framework assumes a maximum outstanding guarantee to outstanding loans ratio of 0.7. We assumed this maximum ratio to apply throughout, hence column 5 is equal to column 4 multiplied by 0.7. The final step is to calculate the guarantee capital needed. The conceptual framework for creating a Belarusian GF anticipates the loan volume to guarantee capital ratio to be 2.5. Thus, the guarantee capital will need to be 2.5 times less than the outstanding guarantees, and hence column 6 equals column 5 divided by 2.5.

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<sup>3</sup> We assume that in real terms the flow of new loans granted in 2005 will be roughly the same as in 2004, as there are no preconditions for substantial changes. This means that in nominal terms the flow in 2005 will amount to about BYR 750 bn. We further assumed 1/3 of this figure to be the likely increase in the flow of new loans to SEs due to the new Guarantee Fund. This means that the Guarantee Fund will create BYR 250 bn of additional loans, bringing the total flow to roughly BYR 1000 bn.

**Table 2. Calculation of the guarantee capital, BYR bn**

	New loans flow	Loans repayment flow	Net flow	Outstanding loans*	Guarantee stock*	Guarantee capital
	(1)	(2)	(3)	(4)	(5)	(6)
January 2006	19.8	0.0	19.8	0.0		
February 2006	18.3	6.6	11.7	19.8	13.8	5.5
March 2006	20.6	12.7	7.9	31.4	22.0	8.8
April 2006	20.7	19.5	1.1	39.3	27.5	11.0
May 2006	21.5	19.8	1.7	40.5	28.3	11.3
June 2006	21.2	20.9	0.3	42.2	29.5	11.8
July 2006	23.2	21.1	2.1	42.4	29.7	11.9
August 2006	20.8	22.0	-1.2	44.5	31.2	12.5
September 2006	20.8	21.7	-0.9	43.3	30.3	12.1
October 2006	21.3	21.6	-0.3	42.4	29.7	11.9
November 2006	18.6	20.9	-2.3	42.1	29.4	11.8
December 2006	23.3	20.2	3.0	39.7	27.8	11.1
January 2007	Σ=250			42.8	29.9	12.0

Note: \* Stock on the first day of the month

The maximum value of the guarantee capital needed during the year (see Table 2, column 6) is BYR 12.5 bn. At the end of 2005 this amount will correspond to about USD 5.8 m, which means that the government will have to provide about USD 2.8 m of funding.

**Recommendation 1.** The amount of guarantee capital for the Belarusian GF should be related to the quantitative objective set by the Ministry of Economy. If this objective is set at an additional flow of BYR 250 bn for loans granted to SEs, then the guarantee capital needs to be about USD 5.8 m, which assumes funding by the government at about USD 2.8 m.

Of course, this model does not provide an exact figure for the amount of guarantee capital needed. However, it agrees with the level of funding suggested by international experience, for example Hungary. Some additional parameters could be considered, for instance the dynamics of non-performing loans or interest payments. The influence of the former will depend on the recovery scheme for non-performing loans, which will be implemented. The influence of interest payments will depend on the share of such payments guaranteed by the Fund. Furthermore looking to future years, the recapitalization scheme should be defined as well. For example, the Hungarian approach was as follows. Initially the guarantee capital of Hitelgarancia that consisted only of registered capital was Ft 4.812 bn<sup>4</sup>. After that, the registered capital was not changed, but the guarantee capital (own equity) has been growing due to retained earnings<sup>5</sup>. Thus, taking into account these circumstances and the chosen objective (an increase in the granted loan volume of BYR 250 bn), the volume of the initial guarantee capital needed will be BYR 12.5 bn. However, in practice this volume could vary depending on the factors mentioned and on the quantitative value of the goal for the GF formulated by the Ministry of Economy.

### 3. What is the best juridical form for the Guarantee Fund

As a rule, GFs are non-commercial organizations, i.e. generating profit is not their basic aim. Instead, their main priority is SE development. From an economic point of view, the criterion of profit generation is one that divides commercial from non-commercial organizations. The same is true when looking at the question from a legal point of view, but there is greater latitude. The civil legislation of practically all countries allows non-commercial organizations to exercise some commercial activity to allow them to achieve their statutory goals. The absence of a legal division between

<sup>4</sup> About USD 57.3 m at the end of 1992 according to the exchange rate at that time.

<sup>5</sup> According to its statutory rules all of Hitelgarancia's profits are retained and none are distributed to its shareholders.

commercial and non-commercial organizations based on their commercial activities leads to a partial misfit between the economic and the legal statuses of the organization. The greater the variety of additional conditions for activity in this or that form, the greater becomes this misfit between the economic and the legal status. Under certain conditions, an entity, which from an economic point of view is a commercial organization may prefer to have the legal status of a non-commercial organization, and vice versa. Therefore, although the Belarusian GF will be a non-commercial organization from the economic point of view, an analysis should be made to determine whether the commercial or the non-commercial form is the best legal form for it. This analysis needs to consider the economic conditions that are legally established for the various legal forms.

The Belarusian Civil Code permits a range of juridical forms, which – as in most countries – can apply to commercial as well as non-commercial entities. Thus, we should first decide whether the GF should in a legal sense be a commercial or non-commercial entity, while the choice of the concrete juridical form can be made later. The decision (commercial vs. non-commercial) should be based on the following criteria that have important impacts on the activity of the GF:

### *3.1. The structure of governance and control of the GF*

The Belarusian Civil Code and other legislative acts define the management structures for commercial organizations rather strictly, while they leave much more leeway for non-commercial organizations. The supreme decision-making body for all commercial organizations must be the general shareholders' meeting, which elects an executive body (either collectively or individually). Moreover, a revision commission is mandated for all types of juridical forms, and in some cases (i.e. joint-stock companies) a supervisory board as well. The exclusive rights and responsibilities of the supervisory board must be defined for each joint-stock company. In the case of a non-commercial organization the structure of governance is primarily defined by its statutes. However, here too, the general meeting of shareholders is the supreme decision-making body, which defines the structures of all subsidiary governing bodies. In the specific case of funds, the legislation foresees the presence of a supervisory board to control the decision-making of all other bodies, the way the fund's assets may be used, and how they relate to the legislation.

The whole structure of governance in both cases is close to the benchmark model of governance needed for a GF<sup>6</sup>. The only remaining issue for discussion in this context is the necessity to have a supervisory board within the structure of governance of the Belarusian GF. But both commercial organizations (joint-stock companies) and non-commercial ones (funds) must have such a board. This question should be analyzed when comparing the various possible juridical forms. This also raises the question of the level of governmental control, which is considered to be the most important issue by the Ministry of Economy. A high level of control is justified as long as it does not interfere with the priority goal of promoting the development of small businesses. At the same time government control must not infringe on the banks' interests. That is why we support the idea of an effective structure of governance with a level of control of the GF by the government, which does not lead to conflicts with the other shareholders. The level of governmental control will determine the manner of conducting and making decisions at the general meetings, which can vary within the two groups being mentioned and will be further analyzed. *In sum, this criterion does not give any preference to either a commercial or a non-commercial organization.*

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<sup>6</sup> For further relevant information see GET-IPM PP/01/05 "Guarantee for SE loans".

### 3.2. Shareholders' rights concerning the funds invested

Concerning shareholders' rights there is a substantial difference between commercial and non-commercial organizations. In the case of non-commercial organizations the shareholders usually lose all rights of ownership in the invested assets<sup>7</sup>, which would cause problems with the principle of free entrance to and exit from the GF capital for banks. Moreover, in the case of liquidating a non-commercial organization, its shares do not retain rights on the assets invested, in fact any remaining assets will normally be directed towards achieving the goals of the non-commercial organization after its creditors' claims have been settled<sup>8</sup>.

As for commercial organizations, its shareholders do retain ownership rights for their shares, which they can sell or claim in case of liquidation of the organization. This provides substantial incentives for banks that could otherwise lose part of their assets, and would maintain the principle of free entrance and exit. *Hence, shareholders' rights are an important argument in favor of a commercial organization.*

### 3.3. Shareholders' responsibilities

Limited liability of the shareholders applies to both groups of organizations, which means that they will not be responsible for the organization's liabilities and vice versa. For commercial organizations this mechanism is somewhat more flexible: shareholders can choose the juridical form either with limited or with subsidiary liability, while the majority of the other conditions remain equal. For non-commercial organizations some subsidiary responsibility applies to consumer cooperatives, leaving limited responsibility for the other juridical forms.

In our opinion limited responsibility is preferable for the GF for both the banks and for the government. This form avoids the investment of extra funds for insurance purposes. *Limited liability offers equal opportunities for both groups of organizations.*

### 3.4. The possibility allocating profits to the shareholders

Profit allocation applies very differently to the two groups being analyzed. Since the legislation assumes non-commercial organizations not to aim at generating profit, it does not allow profit allocation to shareholders. Commercial organizations, however, are created for just this purpose; hence their statutes permit them to allocate profits to their shareholders.

Although generating profits is not the priority goal for the Belarusian GF, profits could be a secondary but significant incentive for attracting the banking sector to invest in the GF<sup>9</sup>. *Under Belarusian conditions where participation by the banks is extremely important this factor should be recognized as significant, which argues in favor of the GF being a commercial organization.*

### 3.5. Tax considerations

Concerning direct taxes, different taxation regimes apply to commercial and non-commercial organizations. Non-commercial organizations are subject to a more favorable taxation regime. This question is important since it is the GF's aim to direct as much money as possible into SE development. At the same time only the net profits of the GF will be taxed, which are not likely to be very large. Consequently the influence on the amount of guarantee capital (as retained earnings) should not be

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<sup>7</sup> There could be some exceptions from the procedure. In consumer cooperatives shareholders retain the rights to their share, but do not retain the rights to the initial share. For the GF this procedure could be included in its own in the statutes.

<sup>8</sup> The procedure of liquidating consumer cooperatives is not very clearly defined.

<sup>9</sup> Recapitalizing the GF requires retaining earnings. However, a small part of the generated profits could possibly be paid out to the shareholders (banks) as an additional instrument to attract them to participate in the GF.

very substantial. As for the indirect taxes, while the main activity of the GF will be concentrated on the financial services, which is not liable to the VAT-tax not depending on the juridical form of organization, there no difference from this point of view. Finally, shareholder investments in the authorized fund of the GF are not subject to VAT in either case. *Thus the taxation regime gives some advantage to a non-commercial organization.*

There are some other factors that could affect the choice of the legal form: the question of financial auditing powers by the controlling bodies, the minimum amount of investment in the statutory fund, and the process of funding the GF equity (guarantee capital). However, in the specific case of establishing the GF these factors will not substantially influence the choice of the juridical form.

The foregoing analysis suggests that establishment of the GF in form of commercial organization have more advantages rather than in non-commercial one. Especially commercial juridical form becomes vital taking in mind creating incentives for banks being sharers of the GF. Hence such factors as possibility of ownership right for invested assets and profit allocation vs. favorable order of taxation with other factors being almost equal leads to the conclusion that the Belarusian GF should be legally established as a commercial organization, despite it should non-commercial in economic sense.

The Belarusian Civil Code allows the following juridical forms for commercial organizations (those advantages listed are peculiar for all of them): partnerships (full and limited), limited and subsidiary liability companies, joint stock companies (open and closed). As stated above we believe that any subsidiary liability condition will increase the risks to shareholders and thus will reduce the number of banks wishing to participate in the mechanism of consolidated guarantees. The Partnership form envisages unlimited subsidiary responsibility<sup>10</sup> hence this form is unacceptable. A Subsidiary Liability Company has lower limits of subsidiary responsibility but it is still worth avoiding this level of responsibility. An Open Joint Stock Company form should not be chosen either because it assumes free circulation of the GF shares without any limits. Instead, the range of owners should be limited and the government should hold a controlling share of the stock in line with the conceptual conditions applying to the Belarusian GF. Thus the choice for the juridical form should be between a Closed Joint Stock Company (CJSC) and a Limited Liability Company (LLC).

Broadly speaking, both forms are acceptable as both of them allow realizing the basic advantages of a commercial juridical form. Nevertheless, there are some differences between them concerning governance and control: the requirement for supervisory boards and the voting rules at general meetings. A supervisory board must be established for a CJSC if the number of participants is greater than 50<sup>11</sup>. As for general meetings, they need 75% of the votes to make decisions within a CJSC, and consensus within an LLC. But in our opinion these factors do not give significant advantages to either juridical form and we consider both of them to be acceptable for the GF.

**Recommendation 2.** The legal status of a commercial organization is preferred over a non-commercial one for the Belarusian GF. Within this group two juridical forms are acceptable: a Closed Joint Stock Company or a Limited Liability Company.

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<sup>10</sup> It could be limited for some partners in the case of a limited partnership.

<sup>11</sup> At present the number of Belarusian banks is 32 and even if all of them would become shareholders in the GF a supervisory board will not be needed. But such a situation could become possible at a future date.

#### **4. What should be the role of the Belarusian Fund for Financial Support of Entrepreneurs?**

While the GF is going to be an organization created just for small business needs, the question arises about how it should relate to already existing organizations in this field.

The USD 5.8 m needed by the GF as guarantee capital is a rather large amount for a one-time investment. Therefore the question arises whether the GF could be created out of an existing organization dealing with a small business development. Moreover the competence and experience of such an organization could play a considerable role in the development of the GF. A possible candidate is the Belarusian Fund for Financial Support of Entrepreneurs (BFFSE).

BFFSE was established in the mid-1990s by the Belarusian government as a body aimed at facilitating the development of SEs through financial support. In 1998, a presidential edict adopted a new regulation for the fund's activity. According to this regulation the main tasks of the funds are the following:

1. Financial provisions to promote the government's policies in the sphere of small and medium-sized enterprises.
2. Accumulating resources for further investment projects directed at establishing, restructuring and providing technical innovation for SEs.

To achieve these objectives the fund is allowed to carry out a range of operations, such as: accumulating optional contributions; granting regular loans, favorable loans, and loans without interest; analyzing investment projects and defining the sources for financing them; granting guarantees to banks, etc. All the property of the fund is state-owned. The fund's board (with up to 15 members) is presided over by the Minister of Economy. The board appoints the head of the executive board, who in turn appoints the other members of the executive board. The executive board reports to the fund's board.

The results of the BFFSE's activities to date are not very impressive, due to the absence of financial inflows and thus limited possibilities to increase the BFFSE's capital and consequently its assets. The main reason of this situation is that the only source of funding derives from the government. Today, the total resource base of the BFFSE is about USD 0.3 m of which almost 100% is equity capital provided by the government, which has not been replenished during the last years. The statute of the fund does not anticipate any borrowing (deposits), and thus only optional contributions could add to the equity capital. However, the present conditions of Belarusian small business and the legislative norms do not create many incentives for such contributions.

The asset operations of the fund are not too successful either. The long-term tendency of interest rate reductions coupled with the fund's obligation to grant a part of its loans at below market levels of interest do not permit it to expand the scope of its activities by means of retained profit. In actual fact, the fund has faced losses of a cumulative value of BYR 57.7 m during 2002-2003. Furthermore, the fund's overdue accounts payable to Priorbank are about USD 17,700.

But the main problem, which illustrates the fund's inadequacy, is its miniscule effect on the development of SEs. The fund's turnover capital is only about BYR 350 m (USD 160,000), while as mentioned above the total volume of bank loans granted to SEs in 2004 was about BYR 670 bn. In 2003 the fund was able to deal with only 52 small enterprises, which is an almost negligible proportion of the total number of SEs in existence.

Regarding the question of either the BFFSE should be reorganized into the GF or not, let us first look at the arguments in favor. There are two such arguments. Firstly, the availability of a definite sum of resources, although this sum is much lower than necessary, and secondly, some experience in the sphere of SE financing.

The arguments against are as follows: Firstly, the equity capital of the BFFSE is too small compared to the minimum needed amount of USD 10 m. Secondly, the experience of granting guarantees on SE's loans also cannot support this idea, as almost 100% of its current assets are connected to loans, but not to guarantees (although this kind of activity is included in the regulation). Thirdly, the conceptual framework for establishing the GF assumes close cooperation with banks, while the fund is 100% state-owned. It would create additional difficulties to restructure the equity to allow for bank participation. Fourth, the management structure of the BFFSE does not comply with the benchmark set for the GF, and would hence have to be restructured. Fifth, the current financial situation of the BFFSE would create problems for the GF, which would have to inherit the BFFSE's debts. The losses incurred during the past years and the insignificant role in SE development have not created a perfect image for the fund as a contractor and hence may have a negative effect on the trust in the new entity when granting guarantees.

Comparing the pros and cons we conclude that the BFFSE should not be reorganized into the GF. Rather, the GF should be a separate new organization. However, one other approach may be possible. Recently the Ministry of Economy launched a draft presidential edict promoting the liquidation of the BFFSE because of its ineffectiveness. In our opinion the liquidation of the BFFSE and the redirection of its capital into the guarantee capital of the GF would be a good move. It would slightly mitigate the problem of finding sufficient resources for the GF's guarantee capital. At the same time there should be no juridical or economic inheritance from the BFFSE in order to avoid the negative consequences described above.

**Recommendation 3.** The Belarusian GF should be a newly created organization and should not be based on a reorganized BFFSE. The only acceptable variant is the liquidation of the BFFSE and directing its resources into the GF's guarantee capital.

## **5. Legal prerequisites for attracting banks to fund the Guarantee Fund**

The conceptual framework for establishing the Belarusian GF assumes that the legislation governing the guarantee fund's operations will include some incentives for banks to participate. These incentives would include: An exclusive right for bank shareholders to be given guarantees for their loans to SEs; the principle that the GF will place deposits with bank shareholders that grant loans under GF guarantees; a bilateral agreement between the GF and each bank shareholder that legally defines their relationship, and quantitative characteristics of the obligations undertaken<sup>12</sup>.

In addition to these measures there should be some additional preparatory legislative steps taken for entice banks to participate in this field. In chronological order banks would face the following problems when making loans on the basis of consolidated guarantees simply because of the present regulations governing banking activities: difficulties with the procedures of granting loans to SEs; obstacles for receiving guarantees from the GF; and a lack of funds as a source for granting loans.

### *5.1. Difficulties with the procedures of granting loans to SEs*

Generally speaking, a bank would prefer to grant loans to relatively larger enterprises, because the value of their operational and administrative costs tend to be fixed and are nearly unaffected by the size of the loans being granted. The procedures for

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<sup>12</sup> For more detailed information see GET-IPM PP/01/05 "Guarantee for SME loans", p. 5-6.

granting loans were simplified within the Belarusian legislation after the new directive "On granting money in the form of loans and their repayment" came into force. Firstly, a micro-loan was explicitly defined as being one for less than 7500 base units. Also, item 11 of the directive makes the procedure for granting micro-loans simpler compared to that for ordinary loans. The directive does, however, not prescribe any specific practical steps for this simpler approach. But the directive does state that the actual conditions of a micro-loan contract (the purposes of the loan, the range of registration documents, the financial documents that need to be submitted, etc.) can now be defined by each bank individually. If realizing the scheme of a risk splitting that is possible through the GF, banks could resort to this procedure of granting micro loans<sup>13</sup> and launch special internal normative acts, regulating this procedure and making it as simple as possible. We believe that the current norms regulating the process of granting loans should allow banks the possibility to minimize administrative costs. Nevertheless we believe that setting out more explicit rules for simplifying the granting of micro-loans, i.e. the minimum portfolio of documents to be submitted by the SE to the bank is desirable. It would tend to avoid some problems for the banks related to the present unclear or implied rules for granting micro-loans, and would also alleviate problems for the controlling bodies.

Moreover, item 13 of the directive limits the possibilities for granting cash loans. On the one hand this could be justified from a monetary point of view, i.e. limiting the amount of currency in circulation. On the other hand, even if all SE loans were made in cash form, the effect on cash money circulation would be very small. Moreover, if cash circulation was a concern, a quantitative limitation (not a general limitation) set by the NBB on a maximum sum for cash loans would make more sense. In international practice, the technology of micro-financing<sup>14</sup> permits small loans to be made in cash as this has many advantages for SEs, most of which tend to have small turnovers. In our opinion the directive should be amended to permit the granting of micro-loans in cash. If cash limitation is deemed desirable a quantitative indicator for maximum cash loans should be set by the NBB.

## *5.2. Obstacles to receiving guarantees from the GF*

Another obstacle contained in the current legislation concerning the guarantee mechanism is contained in item 1.3 of the presidential edict "On measures regulating banking activity in the Republic of Belarus", No 209. It requires that all sureties and guaranties within a loan contract should be covered by collateral from the guarantor. Only a few exceptions are allowed: loan contracts totaling less than 2000 base units concluded by six authorized banks, loans to physical persons made by Belarusbank, and loans to the staff by the NBB. This norm completely contradicts the mechanism of consolidated guarantees. Firstly, the exceptions are made only for authorized banks, while it can be expected that small and medium-sized banks would become the most active participants in the GF mechanism. Secondly, the limit of 2000 base units is substantially lower than that defined for micro-loans in the directive, thus excluding a rather large part of the target group from getting loans. Thirdly, the GF's operational scheme foresees placing deposits in banks as an explicit part of the guarantee granting mechanism, and that in the volume and on the conditions agreed to by the GF and by each individual bank. The new Belarusian GF legislation will provide for guarantee deposits of money, while the edict requires collateral, which is another form of obligations provision.

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<sup>13</sup> While the GF mechanism mainly is assumed for servicing small and medium enterprises, we can suppose that the volume of loan under 7500 of base units (i.e. about USD 85 th) will be enough for them and certainly will be within the category of micro loan.

<sup>14</sup> For more detailed information see GET-IPM PP/12/04 "Proposals for the development of micro-finance institutions in Belarus", pp. 8-9.

A complete revocation of item 1.3 of the edict would eliminate these obstacles to the development of the GF mechanism. At the same time the revocation could lead to further credit risk exposure by the banking system. Thus, taking into account both arguments we consider that at least the first part of this item should be amended to read as follows: "The sureties and guarantees on the loan contract may be provided by the guarantor in the following ways: guarantee deposit of money, transferring the legal title on property or property rights, and/or collateral of the property. Exceptions are sureties and guarantees on loan contracts under the sum of 7000 base units".

### *5.3. Lack of funds as a source for granting loans*

When discussing the mechanism of consolidated guarantees we noted that it would be a source of additional deposits for banks. But a part of these deposits into the GF (the difference between total GF equity and the government's share) will be made by the banks themselves. It does not make sense that that part of the deposits should be subject to the reserve requirements set by the NBB regulation "On norms of compulsory reserves deposited in the NBB", No 44. Normally reserve requirements have two basic functions: regulating the liquidity in the banking sector and limiting the money supply. Since the contributions by banks to the GF decrease the liquidity of the banking system, these contributions should be exempt from the reserve requirements. As for limiting the money supply, the decrease in the reserve requirements for these deposits would not have a substantial influence even if the government's share of the GF was transformed into deposits as well. Hence, we suggest that the banks' contributions to the GF could be completely exempt from the reserve requirements. This would stimulate a recovery of banking liquidity after the initial investments and would not create an excessive money supply.

**Recommendation 4.** Certain norms of the current banking legislation need to be amended:

- 4.1. It should be possible to grant loans in cash up to a certain limit. Also, the procedure of granting micro-loans should be defined in a more explicit way.
- 4.2. The norm that requires collateral by a guarantor under the guarantee agreement should be cancelled or substantially amended.
- 4.3. Bank deposits to the GF should not be subject to reserve requirements.

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