LEVERAGING MECHANISMS

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The PROFIT (Promoting Financial Investments and Transfers) Project seeks to mobilize the resources of the commercial sector to expand and improve the delivery of family planning services in selected developing countries. The PROFIT Project is a consortium of five firms, led by the international management consulting firm of Deloitte Touche Tohmatsu and including the Boston University Center for International Health, Multinational Strategies, Inc., Development Associates, Inc., and Family Health International.

This report is part of a series of PROFIT Research Studies, which address various topics related to private sector family planning. The studies grow out of PROFIT subprojects within the following three strategic areas: innovative investments, private health care providers, and employer-provided services.

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ABSTRACT

Reductions in donor funding for international development activities have made leveraging a key objective for both donors and implementing organizations. Among the strategies that have been used are loans, guarantees, equity financing, debt conversions, co-financing, and cost-sharing. These mechanisms are viable and important means to help increase the funding available to achieve key development objectives, but they should not be pursued solely to create financial leverage. Donors and implementing organizations should continue to focus their attention and resources on achieving their overall programmatic objectives and should employ these leveraging mechanisms only when they clearly contribute to those objectives.

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ACRONYMS

ADB	Asian Development Bank
AEF	Africa Enterprise Fund
AIDSCAP	AIDS Control and Prevention Project
BKKBN	Badan Koordinasi Keluarga Berencana Nasional (National Family Planning Coordination Board, Indonesia)
BRI	Bank Rakyat Indonesia
CA	Cooperating agency
ECA	Enhanced Credit Authority
EU	European Union
FFD	Finance for Development
GOK	Government of Kenya
HIV/AIDS	Human immunodeficiency virus/acquired immunodeficiency syndrome
IBI	Ikatan Bidan Indonesia (Indonesian Midwives Association)
IGO	Intergovernmental organization
LDC	Less developed country
LPG	Loan Portfolio Guarantee
MOH	Ministry of Health
MSED	Micro and Small Enterprise Development
NGO	Nongovernmental organization
ODA	Overseas Development Administration (United Kingdom)
PATH	Program for Appropriate Technology in Health
PROCOSI	Programa de Coordination en Supervivencia Infantil
PROFIT	Promoting Financial Investments and Transfers Project
PVO	Private voluntary organization

SEED	Support for East European Democracy Project
UNFPA	United Nations Population Fund
UNICEF	United Nations Children's Fund
USAID	U.S. Agency for International Development
USAID/G/PHN/POP	U.S. Agency for International Development's Office of Population
WWF	World Wildlife Fund

Over the past twenty years, official development assistance has not kept pace with increasing worldwide demand. To respond to this challenge, donors have used a variety of financial mechanisms to leverage their limited resources. Leveraging mechanisms allow donors and other organizations involved in international development to supplement donor funding with inputs from other project participants and partners, such as commercial banks or entrepreneurs, and thereby to expand the total funding available for development activities. This paper examines the most common leveraging mechanisms: loans, guarantees, equity financing, debt conversion, co-financing, and cost-sharing.

LOAN PROGRAMS

Loan programs are employed to provide funding to a given sector of the economy that may not have access to formal financing sources, typically to expand commercial or economic activity among certain target sectors such as small businesses. Loan programs are particularly effective because they target funding to a particular beneficiary group and because they can leverage donor resources. The leveraging occurs when the funds that are lent are subsequently repaid and relent to new borrowers. Each time the original funds are recycled, the donor has effectively leveraged the reach of its funds by 100 percent. In some cases, the funds are lent in conjunction with other technical or business training, which often increases the efficiencies of the capital borrowed.

The loans can take the form of direct bilateral loans (government to government), multilateral loans (from lending agencies such as the World Bank), and commercial and industrial loans. Two types of loan programs are often used by donor agencies for development projects: on-lending programs and loan funds.

- On-Lending Programs: On-lending is when a donor lends to one or more institutions that then pass the funds on by lending to target borrowers. On-lending programs achieve leverage in two ways. First, participating institutions are usually required to lend their own funds as well as donor funds, thereby increasing the overall pool of funding to borrowers. Second, funds are recycled. On-lending programs target specific population groups in developing countries whose access to credit is limited by their regional or societal marginalization, their lack of collateral, the high transactions costs associated with small loans, or other factors. Donor-supported on-lending programs generally consist of a loan or grant made to a management or "apex" entity (usually within a host government ministry or the central bank), which subsequently on-lends the funds through the formal banking system to the designated borrowers, organizations, or structures.

Loan Funds: Loan funds function much like on-lending programs in that they normally target particular sectors of the economy (e.g., agro-businesses) or classes of borrowers (e.g., private physicians). However, loan funds tend to be administered by only one lending institution rather than by multiple organizations or through an apex arrangement. Thus, loan funds follow well-defined lending criteria and repayment terms and conditions, which are generally structured between the donor and the administering institution. The success of loan funds is very much tied to the capabilities and geographic presence of the lending institution. In addition, the amount of leverage may be enhanced if the lending institution contributes its own funds to the loan fund.

GUARANTEES AND GUARANTEE FUNDS

Loan guarantees are credit instruments that are issued by a donor or financial institution to guarantee payment of a loan on behalf of its customers to a beneficiary, normally a third party, for a stated period of time and under certain conditions. Guarantees are used by donors to increase credit flows through normal commercial banking channels to groups or individuals who are considered high credit risks and who therefore lack access to capital. In addition, guarantees are used by donors to mobilize funding from local sources for a particular project by providing local investors with some cushion against potential risks. Usually, the guarantor agrees to cover a percentage of loan principal lent by the bank, although some guarantees cover a percentage of principal and interest. The guarantee reduces the bank's risk, thereby allowing the bank to lend to borrowers who have insufficient collateral.

Guarantees leverage donor funds by attracting funding from commercial banks and other intermediaries to finance development activities. Mor important, the donor (as a guarantor) does not have to expend funds unless it is called upon to settle a loss or nonpayment. A donor or guarantee fund will generally spend an equal amount of time and resources analyzing a project for direct lending purposes as it will to act as a guarantor.

EQUITY FINANCING

Equity financing represents a more complex way to provide funding to development projects. In essence, equity financing is the provision of capital through a direct ownership stake in a company or project. Donors have primarily relied on loan mechanisms or guarantees to channel funds into the private sector, but new programs have been established in recent years to provide seed capital to entrepreneurs in priority countries, such as Russia and Eastern Europe.

Equity financing can leverage donor funds by attracting other funding, such as commercial bank loans and guarantees, as well as financial resources from entrepreneurs who are setting up new projects or companies. Leveraging can also occur if the projects are successful and the equity share yields large dividends or a sizable payoff for the organization.

The practice of funding projects or programs with equity is quite demanding. It requires an organizational infrastructure to identify and select projects, analyze business prospects, and negotiate an ownership role and stake. For these reasons, donors have relied on existing development finance organizations or have established new venture funds, such as the Africa Enterprise Fund (AEF), in order to channel equity capital for development projects.

DEBT CONVERSIONS

When developing countries became unable in the 1980s to service their outstanding debt to commercial banks (primarily in Western Europe and the United States), financiers created a secondary market for this debt. The debt was sold at a discount to other banks or organizations, who then negotiated favorable terms with developing countries to convert the debt instruments into local currency or assets in the debtor country.

One of the most popular conversion techniques was debt-for-equity conversions or swaps, in which corporations purchased government debt from a bank at a discount and exchanged it for equity in state-owned enterprises. This type of conversion was used to undertake debt-for-development transactions in the late 1980s, which involved nongovernmental organizations (NGOs). The NGO purchased debt on the secondary market and exchanged the debt with central bank authorities in the particular developing country at a prearranged exchange rate. The central bank paid the NGO in local currency, and the NGO used the proceeds to finance development projects, particularly in environmental conservation, health, or education.

The NGO leveraged its funds by receiving a premium in local currency for the debt it had purchased using its foreign exchange. The commercial bank was able to retire its outstanding loan, which was not being serviced, at a discount. The developing country repaid its obligation in local currency, while funding important social development projects.

Debt conversion programs of all types have declined in recent years, and many debt traders and analysts currently view the opportunities for debt-for-development to be quite limited as a result of rapid changes in the emerging markets. These limitations, coupled with the high transaction costs, long negotiation periods, and large amounts of paperwork, make such transactions much less attractive to most NGOs than in the past.

CO-FINANCING

Co-financing is a funding mechanism used by development agencies seeking to leverage limited funds. The practice involves joint or parallel funding of specific projects by a number of donors, each of which finances the portion of a project that suits their interests. The process of identifying projects takes place through formal and informal channels, and the financing takes the form of loans, guarantees, or grants. Co-financing arrangements are usually structured either as joint financing (i.e., the financing of all or certain contracts in agreed portions) or as parallel financing (i.e., where donors finance different components or different goods and services).

The leveraging effect from co-financing is limited unless it can be shown that the action of one donor had the effect of enticing other donors to support a given project. Thus, co-financing can play a role in mobilizing funding from multiple donors, but it is not fundamentally designed to leverage such funds.

COST-SHARING

Cost-sharing occurs when an organization, such as an NGO, is able to encourage other donors or private sector organizations to donate in-kind contributions of commodities or services to a project. The resources that can be leveraged include commodities, equipment, the use of assets such as buildings, lobbying support, human resources, and services.

Cost-sharing falls outside the strict definition of financial leveraging. The intent of cost-sharing is to diversify or supplement funding for development projects among multiple donors and private sector contributors. Such efforts are usually spearheaded by the organizations that are implementing a particular project or development activity. Cost-sharing provides greater exposure for a project within the community and may thereby attract more support, new funding, or in-kind resources. This type of leveraging also has been employed by health and population organizations that face decreased support from traditional donors as a means of diversifying their funding bases.

FACTORS FOR SUCCESS

In general terms, the ability of various financial mechanisms to generate leverage will depend on the specific circumstances of the project. There are several key factors that will affect the success of any effort to use leveraging mechanisms, and these should be carefully considered by donors and implementing organizations.

Partners: The institutions and organizations involved in developing and implementing the mechanism are critical to the success of any financial leveraging activity. An institution's track record, management capabilities, and commitment to a particular development objective must be considered.

Leveraging Potential: The potential for financial gain must be weighed against the risk of losses to the beneficiaries, donors, lenders, or other partners.

Control: The use of leveraging mechanisms affects donors' control over a particular project, particularly the use of donor funds and the ability to reach the intended beneficiaries. Donors should carefully consider the potential that their control may be limited and should develop appropriate monitoring mechanisms.

Costs: The costs to donors, lenders, or other financial partners include the transaction costs (including the cost of assessing and developing the program), the implementation costs, and the costs of technical assistance or training. These should be realistically estimated and weighed against the potential gains.

Timing: The time needed to launch a leveraging program and the time that will elapse before any gains are realized will differ considerably for each mechanism.

Limitations: Certain mechanisms are appropriate and effective only under certain conditions. Donors should carefully assess whether the necessary preconditions are met and whether the overall environment is conducive to success.

STRATEGIES FOR THE FUTURE

Donors contemplating the use of leveraging mechanisms should carefully assess the comparative advantages of using this approach versus others that might help achieve their specific program objectives.

Credit mechanisms, including loans, guarantees, or equity funding, are more appropriate when access to capital is a fundamental requirement for attaining the program's objectives. Use of credit mechanisms in health or population programs should be carefully assessed to ensure they it will contribute significantly to the achievement of a given project's fundamental objectives.

Using credit mechanisms effectively and efficiently requires extensive organizational infrastructure. Donors should utilize existing organizations as much as possible to minimize the implementation and program costs.

Guarantees, loans, and equity financing (in that order) generally require relatively lesser amounts of funding to achieve leveraging results. The length of time to produce comparable leveraging results also will generally follow this order.

Successful debt conversion programs involve extensive research, negotiation, transaction costs, and time. The opportunities to realize sufficient financial gains have been significantly reduced by recent changes in the market for secondary debt. As a result, debt conversion should be pursued only by organizations that have sufficient institutional expertise, resources, and experience.

The success of efforts to set up co-financing and cost-sharing arrangements — which are not traditional financial leveraging mechanisms — depends largely on whether the donors and implementing agencies involved are able to coordinate their activities and negotiate suitable arrangements for pooling and sharing their resources.

In sum, leveraging mechanisms should be viewed primarily as tools to achieve broader development objectives. Although their use may be an appropriate and effective means to augment diminishing development funds, they should be used only if they further the overall development objectives of an organization or program. Donors and implementing agencies that consider options for leveraging their limited funds must assess whether a particular leveraging mechanism is appropriate, whether the potential financial gains outweigh the costs, and whether the effort stands a reasonable chance of success. Fundamentally, however, they must determine whether the use of such mechanisms is the most effective and efficient means to pursue their broader goals and objectives.

1.0 INTRODUCTION

Throughout the past decade, development theorists and practitioners have debated the means by which to increase or extend limited international aid funds. Over the past twenty years, official development assistance has not kept pace with increasing worldwide demand. With reductions in direct grant funding for international technical assistance, the ability to leverage limited funds to create sustainable development projects is increasingly important to donor agencies. To respond to this challenge, donors have used a variety of financial mechanisms to leverage their limited resources, including traditional mechanisms, such as lending programs and guarantees, and newer techniques, such as debt conversion, equity funding, and co-financing. These mechanisms have been utilized in projects across a large number of functional disciplines, such as agriculture, small business, energy, health and population, and natural resources.

This report provides an overview of the basic mechanisms used to leverage development funds, with an emphasis on financial mechanisms. It examines the factors that affect the success of such efforts and explores how donors have used financial mechanisms to pursue their development objectives. In addition, the report covers some of the cost-sharing and funding strategies being used by organizations that receive donor funding to increase the funds available to support their activities. The document also examines how these mechanisms have been used in the health and population field and provides a look at the likely future of endeavors in this area.

1.1 DEFINITIONS AND BACKGROUND

According to the dictionary, "leveraging" means power, effectiveness, as well as the use of credit to enhance one's speculative capacity.[1] The term carries an implicit notion of increasing the reach or efficiency of resources, particularly financial assets.

In corporate finance, leverage is defined in the context of maximizing or improving profitability through the use of debt. Corporations attempt to increase their financial leverage by using debt financing rather than equity from owners or shareholders. This practice has some advantages, specifically, that interest charges on debt are tax-deductible. However, it also increases business risk because companies assume a fixed repayment obligation that equity funding does not normally carry.

In international development, leveraging is interpreted as a means to supplement funds or resources that are contributed to a project. For development practitioners, leveraging involves obtaining incremental

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[1] *Webster's Ninth New Collegiate Dictionary.* Springfield, MA: Merriam-Webster Inc., 1991.

funding or resources to carry out additional activities, as opposed to expanding the reach of their original funds or resources.

For the purposes of this report, leveraging is considered to encompass both of these meanings: it is a mechanism for expanding limited donor funds through financial mechanisms, transactions, and strategies and for supplementing those funds with additional resources. This report covers the most common leveraging mechanisms:

- Loans
- Guarantees
- Equity financing
- Debt conversions
- Co-financing
- Cost-sharing

These mechanisms have been used separately and in various combinations to leverage donor funding for a particular project or activity. They share the common goal of supplementing donor funding with inputs from other project participants and partners, such as commercial banks or entrepreneurs, so that the total funding available for the development activity is greater than the donor's contributions. There are other means of enhancing the resources available for development activities, including the leveraging human resources, physical infrastructure, and organizational knowledge, among others. These dimensions of leveraging, while important, are not addressed here.

2.0 LEVERAGING MECHANISMS FOR DEVELOPMENT

This section examines the more prevalent financial leveraging mechanisms and strategies used in donor funded projects:

- Loan Programs
- Guarantee Programs
- Equity Financing
- Co-financing
- Debt Conversions
- Cost-sharing

The essential characteristics of each mechanism are described, the formal and informal organizational structures that have been utilized to implement these mechanisms are outlined, and examples of each mechanism are provided where relevant.

2.1 LOAN PROGRAMS

Loan programs are one of the most common mechanisms for implementing development projects, particularly those that target private sector development or collaboration. Loan programs are employed by donor agencies, governments, nongovernmental organizations (NGOs), intergovernmental organizations (IGOs), and development finance companies to provide funding to a given sector of the economy that may not have access to formal financing sources. The intent of loan programs is typically to expand commercial or economic activity among certain target sectors such as small businesses.

Loan programs are particularly effective because they target funding to a particular beneficiary group (e.g., micro-entrepreneurs) and because they can leverage donor resources. Leveraging through loan programs occurs when the funds that are lent are subsequently repaid and relent to new borrowers. The funds are recycled, allowing many more individuals to have access to financing than possible through a grant mechanism. Each time the original funds are recycled, the donor has effectively leveraged the reach of its funds by 100 percent. The time period during which this leveraging takes place varies, depending on the repayment terms for the loans, which can vary between a few months and up to five years. In some cases, the loan programs offer borrowers technical or business training, which can increase the efficiency of the capital.

Loan programs for development projects can take the form of direct bilateral loans (government to government), multilateral loans (from lending agencies such as the World Bank), commercial loans, loan funds, on-lending programs, and others. Interest rates vary depending on the lender and the loan program's objectives. The funds tend to be lent for specific periods of time and are repaid with interest. Commercial entities lend at commercial rates, and governments and donor agencies generally lend at lower rates (in effect, at subsidized rates).

Loan programs require an established, if not sophisticated, delivery infrastructure to identify potential borrowers, process and approve loan requests, disburse funds, collect repayments and interest charges, and ensure that loan losses are minimized. Donors normally look to existing financial institutions such as commercial banks or micro-lending banks to deliver such programs. They tend to work with those organizations that have experience lending to the target populations or the required presence in certain geographic locations. Donors may also work through ministries of finance or central banks to channel funds to participating financial institutions under an apex arrangement (described below), or they may choose to work with a specific bank or organization.

Because of the need to work through intermediaries, donors may relinquish a certain amount of control over the way loan programs are administered and, potentially, over their ability to reach and influence the targeted population groups. This factor may be more important for loan programs that target new borrowers or groups that have not traditionally had access to formal lending sources. In these cases, the donor and the lending institution must develop strategies for attracting new borrowers to the programs.

Below are descriptions of two types of loan programs used by donor agencies for development projects: on-lending programs and loan funds.

2.1.1 On-Lending Programs

"On-lending," a variation of traditional lending, was developed as a financial mechanism to address situations in which institutionalized or commercial credit was unavailable for a given group. The practice is called on-lending because the donor lends to one or many institutions who then pass on the funds by lending to the targeted borrowers.

On-lending programs achieve leverage in two ways. First, participating institutions are usually required to lend their own funds as well as donor funds, thereby increasing the overall pool of funding to the targeted group of borrowers. Second, the funds are recycled — repaid by borrowers and relent to new borrowers.

On-lending programs are generally supported by international financial institutions such as the World Bank that target specific population groups in developing countries. These groups include indigenous groups, women entrepreneurs, or small and micro-entrepreneurs whose access to credit may be limited by geographic remoteness, social position, lack of collateral, the high transactions costs associated with small loans, or other factors. Donor-supported on-lending programs generally involve a loan or grant that is made to a management or “apex” entity (usually within a host government ministry or the central bank), which subsequently on-lends the funds through the formal banking system to the designated borrowers, organizations, or structures.

On-lending programs can be quite effective in reaching large numbers of small borrowers, but they require a well-trained and well-managed organization to coordinate activities with participating financial institutions. Additionally, on-lending programs are very much influenced by the macroeconomic environment of the host country, the sophistication of the banking system, and the profile of intended borrowers. Such programs also require technical assistance to the financial institutions. One World Bank survey showed that technical assistance in support of on-lending programs made up about 4 percent ($150 million) of the total World Bank small or medium enterprise loans ($3.7 billion) during 1973–1991.

One successful apex on-lending program is USAID’s Kenya Private Rural Enterprise Program (RPE), which was established in 1983 with an agreement between the Government of Kenya and USAID. USAID loaned the Government of Kenya $24 million for on-lending to entrepreneurs, which was channeled through Kenya’s Ministry of Finance to the central bank and then on-lent to participating banks at an interest rate of 12 percent. USAID’s contributed two-thirds to each loan, and participating banks contributed the remaining third. Through this mechanism, USAID’s funds were leveraged by additional funds from the participating banks, who were able to earn a small margin on the funds lent.

2.1.2 Loan Funds

Loan funds function much like on-lending programs in that they normally target particular sectors of the economy (e.g., agro-businesses) or classes of borrowers (e.g., private physicians). However, loan funds tend to be administered by only one lending institution rather by than multiple organizations or through an apex arrangement. Thus, loan funds follow well-defined lending criteria and repayment terms and conditions, which are generally structured between the donor and the administering institution. The success of loan funds is very much tied to the capabilities and geographic presence of the lending institution. In addition, the amount of leverage may be enhanced by the lending institution, if it contributes its own funds to the loan fund. Specific examples of loan funds include:

PROFIT Revolving Loan Fund for Midwives: PROFIT worked in conjunction with the Indonesian Midwives Association (Ikatan Bidan Indonesia or IBI); BKKBN, the government family planning agency; and Bank Rakyat Indonesia (BRI), the largest micro-enterprise bank in the country to establish a loan fund for Indonesian midwives who want to establish or expand their private practices in family planning and reproductive health.

The fund was capitalized by PROFIT and BRI for $500,000 each, creating a revolving loan fund of $1,000,000. The loan fund makes loans in amounts ranging between $1,000 and $2,500. Loans currently fall into three categories: working capital, small investment, and a combination of both. The loans are offered at favorable interest rates, and borrowers have up to three years to repay. IBI has responsibility for screening and recommending midwife loan applicants to BRI and making suggestions on loan terms, sizes, uses, and repayment schedules. The loan fund operates in five Indonesian provinces, seeking to shift family planning clients from the public sector to the private sector and to institutionalize the fund within BRI after the three-year pilot operation ends. By March 1997, over 450 loans had been made to midwives, and over $1,000,000 had been disbursed. Repayment rates were nearly 100 percent. In terms of leveraging, the fund has already leveraged 100 percent of USAID funds with BRI's matching capitalization ($500,000), which will double once the fund has fully revolved in early 1998.

PATH's Fund for Technology Transfer: The Program for Appropriate Technology in Health (PATH) is a U.S.–based nonprofit organization whose mission is to improve health, especially of women and children in developing countries. PATH developed a Fund for Technology Transfer in 1981, which lent over $5 million to projects in 12 countries. The lending program serves small to medium-sized organizations in developing countries, offering loan financing and technical assistance to support health and family planning initiatives. The Fund provides loans of up to $600,000 to health care product manufacturers, distributors, health care providers, and NGOs serving the health sector. The loan terms are decided case by case, with interest rates generally ranging from 9 percent to 12 percent and loan maturity periods from 3 to 7 years. There has been a default only once in the past 15 years, representing a default rate of approximately 4 percent.[2] Collateral is required for all loans. The Fund has supported condom social marketing in Indonesia; the production of a new, once-a-month injectable contraceptive in Mexico; and a manufacturer of a low-cost HIV diagnostic kit in Thailand. The Fund's original focus was to provide loan assistance to manufacturers and distributors of technology for the health sector. Increasingly, however, PATH has loaned to health care providers, as well as to local intermediaries who then on-lend directly to grassroots groups.

[2]"Improving the Health of Women and Children in Developing Countries," *Facts About the Fund, August 1981-August 1993.* (Seattle: Program for Appropriate Technology in Health, 1994).

2.2 GUARANTEES AND GUARANTEE FUNDS

Loan guarantees are credit instruments that are issued by a donor or financial institution to guarantee payment of a loan on behalf of its customers to a beneficiary, normally a third party, for a stated period of time and under certain conditions. Guarantees are used by donors to increase credit flows through normal commercial banking channels to groups or individuals who are considered high credit risks and who therefore lack access to capital. In addition, guarantees are used by donors to mobilize funding from local sources for a particular project by providing local investors some cushion against potential risks.

Usually, the guarantor agrees to cover a percentage of the principal lent by the bank, although some guarantees cover a percentage of principal and interest. The guarantee reduces the bank's risk, thereby allowing the bank to lend to borrowers who have insufficient collateral. For example, if the guarantee covers 50 percent of the amount lent, then the bank will suffer losses only when more than 50 percent of the loan is defaulted. If the guarantee covers 50 percent of the amount lost, however, the bank and the guarantor will equally share all losses.

In order for guarantee mechanisms to work well, there must be a well-defined incentive structure for participating financial institutions to lend to targeted sectors and for the guarantor and lender to share risks on an equitable basis. The structure of guarantee mechanisms or funds requires careful definition in terms of decision-making, fee structures, and risk-sharing criteria.

Guarantees leverage donor funds by attracting funding from commercial banks and other intermediaries to finance development activities. More important, the donor (as a guarantor) does not have to expend funds unless it is called upon to settle a loss or nonpayment. Thus, if a donor experiences losses on only 10 percent of the transactions it guarantees, it can leverage its funds tenfold. In order to achieve such results, however, the donor must carefully assess its potential exposure by analyzing the particular projects it will guarantee or working through an intermediary institution (e.g., a guarantee fund). From an operational standpoint, a donor or guarantee fund will generally spend an equal amount of time and resources analyzing a project for direct lending purposes as it will to act as a guarantor.

Below are descriptions of three guarantee funds supported by USAID.

- **ACCION International's Latin America Bridge Fund:** ACCION International's Latin America Bridge Fund was founded in 1984, with seed money from USAID, to meet the growing demand for capital to fund the micro-loan portfolios of ACCION affiliates. ACCION, a nonprofit organization, works with a network of organizations in Latin America and the United States offering "fair rate" loans and basic business training to micro-enterprises. The Bridge Fund enabled these micro-enterprises to gain access to local capital markets. The fund is capitalized with loans and donations from foundations, institutions, religious orders, and individuals, and is deposited in a trust account at a U.S.

bank. The fund's investment proceeds cover interest payments to its lenders. At the same time, these assets are used as collateral to back guarantees to local banks that make lines of credit available to ACCION's affiliates.

By the end of FY1994, the Bridge Fund had an asset base of $5.8 million and operated 24 programs in 18 Latin American countries and in the United States. In 1994, ACCION's associate programs provided $289 million in micro-loans, with an average loan size of $580. About 98 percent of the loans were repaid in full. Due to its high success rate over the past 10 years, the Bridge Fund claims a leverage ratio of $8.8 to $1.[3] Additionally, because of the close working relationship with, and institutional commitment to ACCION, its affiliates were deemed less likely to default on loans because this would trigger a call on ACCION's guarantee by the bank, potentially jeopardizing the relationship.

USAID Loan Guarantees: USAID utilizes loan guarantees through several programs, most notably the Micro and Small Enterprise Development (MSED) Program's Loan Portfolio Guarantee (LPG).[4] Created in 1988, the LPG provides guarantees to qualifying private banks in developing countries, specifically for small business. The MSED Program guarantees up to 50 percent of the principal losses (in local currency) on a portfolio of small business loans and up to 70 percent of principal losses for micro-loans made by a participating financial institution or intermediary financial institution. Participating financial institutions must be private, have sound financial practices, and agree to the conditions of the guarantee and the types of loans as outlined by USAID. MSED-guaranteed loans may not exceed the local currency equivalent of $25,000 in net fixed assets (excluding land and buildings). Loan terms are generally five years, although extensions are possible in certain cases.

Like other loan guarantee programs, MSED offers guarantees to financial institutions as a risk-management tool, but also hopes to use the program to develop the local credit capacity for small businesses by demonstrating the profitability of this type of lending. As a result of this program, USAID has been able to leverage its own resources.

[3]?A Decade of Guaranteeing Success." *ACCION International Bulletin: Creating Income and Employment in The Americas*. ACCION International. Volume XXX, Number 1 (Winter 1995).

[4]MSED is managed by the Credit and Investment Staff of USAID's Center for Economic Growth.

Historically, for every $1 appropriated to the program, MSED has been able to mobilize $25 in micro- and small business loans.[5]

Enhanced Credit Authority: In 1994 USAID submitted a proposal in support of an omnibus program called the Enhanced Credit Authority (ECA). The program would provide loan guarantees and loans to allow USAID to more broadly accomplish the purposes of the Foreign Assistance Act by providing credit assistance to a wide range of sustainable development projects. The Office of Management and Budget (OMB) approved a $10 million credit subsidy based on the proposal. Congress was expected to approve ECA for implementation during FY96, but following intense federal budget negotiations, it was decided to postpone consideration of ECA until FY97.

The ECA, if approved, is expected to bring about important development advantages. The ECA would create more bankable development projects in a typical USAID mission's portfolio by relying on "credit assistance" rather than grant assistance to demonstrate the sustainability of certain activities. When initially presented for approval, USAID estimated that the ECA could achieve a leverage ratio of about 7 to 1 — meaning that every dollar of USAID loans and guarantees would attract seven dollars of external capital.[6]

2.3 EQUITY FINANCING

Equity financing represents a more complex way to provide funding to development projects. In essence, equity financing is the provision of capital through a direct ownership stake in a company or project. Donors, such as the World Bank and USAID, have primarily relied on loan mechanisms or guarantees to channel funds into the private sector. However, new programs have been established in recent years through development organizations to provide seed capital to entrepreneurs in priority countries, such as Russia and Eastern Europe.

Equity financing can leverage donor funds by attracting other funding, such as commercial bank loans and guarantees, as well as financial resources from entrepreneurs who are setting up a new project

[5]The MSED program claims that this is its historical leverage, which includes non-disclosed weighted factors for country and political risk.

[6]The Enhanced Credit Program, Program Justification, Washington, DC: U.S. Agency for International Development, September 6, 1994.

or company. Leveraging can also occur if the projects are successful, and the equity share yields large dividends or a sizable payout.

The practice of funding projects or programs with equity is quite demanding. It requires an organizational infrastructure to identify and select projects, analyze business prospects, and negotiate an ownership role and stake. For these reasons, donors have relied on existing development finance organizations or have established new venture funds, such as the Africa Enterprise Fund (AEF), in order to channel equity capital for development projects. This approach is obviously time-consuming and requires a heavy investment. Because equity finance involves long-term investments, the potential for immediate leverage is quite low, and there is always a risk that the higher returns will not materialize or that losses will erode the donor's funding.

2.4 DEBT CONVERSIONS

Debt conversions emerged as a result of the debt crisis of the 1980s. When developing countries were unable to service outstanding debt to commercial banks (primarily in Western Europe and the United States), financiers created a secondary market for this debt. The debt was sold at a discount to other banks or organizations, who then negotiated favorable terms with developing countries to convert the debt instruments into local currency or assets in the debtor country.

One of the most popular conversion techniques was debt-for-equity conversions or swaps, in which corporations purchased government debt from a bank at a discount and exchanged it for equity in state-owned enterprises. This type of conversion led to debt-for-development transactions in the late 1980s, which involved NGOs and environmental conservation groups. The NGO purchased debt on the secondary market and exchanged the debt with central bank authorities in the developing country at a prearranged exchange rate. The central bank paid the NGO in local currency, and the NGO used the proceeds to finance development projects, particularly in environmental conservation, health, or education.

The NGO leveraged its funds by receiving a premium in local currency for the debt it had purchased using its foreign exchange. The commercial bank was able to retire its outstanding loan, which was not being serviced, at a discount. The developing country repaid its obligation in local currency, while funding important social development projects.

Both commercial debt-equity swaps and debt-for-development swaps involve identifying a viable use for the local currency within the developing country in order for the transaction to be approved. Therefore, engaging in debt conversion activities requires substantial amounts of both time and investment on the part of banks, NGOs, and other entities involved. Successful conversions are also highly dependent on market influences. Like other commodities, supply and demand affect the price of the debt. A higher price on the debt in the secondary markets reduces the premium that can be made on a conversion. Some organizations such as Finance for Development (formerly, Debt for Development Coalition), use general guidelines stipulating that there be a minimum premium of 25–30 percent over the basic foreign exchange transaction to make the process profitable.

Debt conversion programs of all types have declined in recent years, from about $39 billion in 1990, to about $9 billion in 1995. Of these, debt-for-development swaps accounted for less than $100 million in 1995.[7] Many debt traders and analysts currently view the opportunities for debt-for-development to be quite limited as a result of rapid changes in the emerging markets that have made it impossible to capture high gains. These limitations, coupled with the high transaction costs, long negotiation periods, and large amounts of paperwork, have made such transactions much less attractive to most NGOs.

Among the organizations that continue to successfully use debt-for-development swaps are the United Nations Children's Fund (UNICEF), the World Wildlife Fund (WWF), and Finance for Development (FFD).

- **UNICEF's Debt-for-Child Development Swaps:** UNICEF was the first to pioneer debt-for-development swaps in 1989 and has completed over 20 debt conversions in ten different countries.[8] Under the debt-for-child development program,[9] UNICEF national committees were able to generate $53 million in local currency on the secondary market, at a cost of $29 million, while retiring over $199 million in sovereign debt. The funds from the conversions went to support programs for primary education, women in development, children in especially difficult circumstances, primary health, and water supply and sanitation.

- **World Wildlife Fund's Debt-for-Nature Swaps:** WWF has been very active in debt-for-nature conversions. In 1993, WWF completed a $19 million debt-for-nature conversion in the Philippines. USAID provided $12.97 million to WWF to purchase the $19 million, at 68 percent of its face value. The debt was redeemed in local currency worth $17.1 million (or 90 percent of the face value), which went to environmental and

[7] World Bank. *World Debt Tables, 1994–1995*. Volume 1, Appendix 6. (Washington, DC: World Bank, 1996).

[8] These countries include: Bolivia, Jamaica, Madagascar, Mexico, Peru, Philippines, Senegal, Sudan, and Zambia. World Bank. *World Debt Tables, 1995–1996*. (Washington, DC: World Bank, 1996), 89.

[9] The UNICEF Debt-for-Child Development initiative was designed to mobilize funding sources to improve development programs geared towards children and women, especially in the areas of primary education, primary healthcare and water supply and sanitation.

conservation projects, including the creation of an endowment fund for the Foundation for the Philippine Environment.

- **Finance for Development and PROCOSI:** Since 1991, FFD, a development finance company, has been instrumental in raising about $69 million through debt conversions for a variety of development projects. About $46 million was paid to reduce $175 million in sovereign debt, and the local currency was used for health, community development, eco-tourism, refugee assistance, education, low-income housing, agriculture, environment, and population projects. In May 1994, FFD completed its most successful and well-known debt conversion on behalf of Programa de Coordination en Supervivencia Infantil (PROCOSI), in conjunction with ten internationally recognized NGOs including CARE, Catholic Relief Services, Plan International, and Save the Children. The transaction involved the purchase of $31.25 million of Bolivian commercial external debt from eight creditors in Europe, Canada, and the United States at 16 percent of the face value. The debt was redeemed in Bolivia for 24 percent of face value. This provided PROCOSI with a 50 percent premium. The proceeds went to strengthen more than 20 Bolivian organizations involved in maternal health and child survival.

2.5 CO-FINANCING

Co-financing is a funding mechanism used by development agencies seeking to leverage limited funds. The practice involves joint or parallel funding of specific projects by a number of donors. The process of identifying projects takes place through formal and informal channels, and the financing takes the form of loans, guarantees, or grants.

Most donors, including the World Bank, are only able to provide a portion of the financial resources required for large development projects, and they therefore actively encourage co-financing. The World Bank, for example, funded $8.2 billion in co-financed projects in 1995, out of a total portfolio of about $22.5 billion.[10] Co-financing arrangements are usually structured either as joint financing (i.e., the financing of all or certain contracts in agreed portions) or as parallel financing (i.e., where donors finance different components or different goods and services). Some donors, such as the United Nations Population Fund (UNFPA), have used other types of co-financing arrangements, including donor cost-sharing and multilateral and bilateral trust funds and parallel financing.[11]

[10]World Bank, *Annual Report 1995.* (Washington, DC: World Bank, 1996).

[11]Approximately 10 percent of UNFPA's 1995 funding was channeled through co-financing programs.

Co-financing provides donors with an opportunity to take advantage of other institutions' expertise and capabilities. For example, a donor funding a program administered by UNFPA could take advantage of UNFPA's extensive field presence to implement other development activities.

Co-financing also allows donors with common objectives to jointly fund a project of mutual interest. In Bangladesh, the Rockefeller Foundation is helping to establish a new organization, Partners in Population Development, which will help NGOs develop and seek funding for population activities. Rockefeller is providing operational support to set up the organization's secretariat in Bangladesh and has coordinated funding from the World Bank and UNFPA to co-fund the organization's $1.4 million annual program budget. In a similar vein, USAID was able to convince other donors, including UNFPA, the Asian Development Bank (ADB), the World Bank, and the United Kingdom's Overseas Development Administration (ODA), to continue funding development activities in Pakistan after USAID phased out its activities in that country several years ago.

Co-financing is a strategy best suited to achieving a more diverse distribution of funding among multiple donors. The leveraging effect from co-financing is limited unless it can be shown that the action of one donor had the effect of enticing other, reluctant donors to support a given project. Thus, co-financing can play a role in mobilizing funding from multiple donors, but it is not fundamentally designed to leverage donor funding.

2.6 COST-SHARING

Cost-sharing occurs when an organization, such as an NGO, is able to encourage other donors or private sector organizations to donate in-kind contributions of commodities or services to a project, such as commodities, equipment, the use of assets such as buildings, lobbying support, human resources, and services.

Cost-sharing falls outside the strict definition of financial leveraging. The intent is to diversify or supplement funding for development projects among multiple donors and private sector contributors. Such efforts are usually spearheaded by the organizations that are implementing a particular project or development activity.

Cost sharing has been employed by many NGOs and PVOs (private voluntary organizations), particularly in the field, as a way to obtain the participation and support of the host community. It also provides greater exposure for a project within the community and may thereby attract more support, new funding, or in-kind resources. This type of leveraging has been employed by the health and population organizations that face decreases in the support they receive from traditional donors (e.g., USAID) as a means of diversifying their funding bases.

2.6.1 Leveraging In-Kind Resources

A traditional strategy employed by implementing agencies is to seek in-kind support from private sector organizations, such as the use of facilities, access to personnel with specialized skills, or donations of commodities or services.

AIDSCAP (AIDS Control and Prevention Project), a long-term USAID project run by Family Health International, works to provide technical research and policy leadership in the global effort against HIV/AIDS. AIDSCAP has been successful in leveraging significant support from the private sector for its HIV prevention program in Brazil, particularly in São Paulo and Rio de Janeiro. AIDSCAP was also successful in getting advertising and editorial coverage from *Claudia,* the second-largest-circulation magazine in Brazil. For example, the magazine agreed to publish a series of 12 articles on technical information related to HIV and AIDS in order to disseminate the work of AIDSCAP.[12]

2.6.2 Donor Diversification

Some implementing organizations pursue cost-sharing as a means to diversify their funding bases in response to budget cuts by their traditional funders. Many cooperating agencies (CAs) that have worked with USAID in health and population programs have been seeking to diversify their funding sources, but their efforts have been impeded by a lack of established contacts with other CAs and donors, many of which (like the European Union) are just beginning to emphasize population programs. In addition, there is a preference among such donors to work with organizations from within their member countries and, in some cases, a lack of in-house technical resources to design and fund new programs and to secure the involvement of U.S.–based organizations. Finally, there are divergences in the geographic priorities of donors. For example, the European Union tends to focus on Asian and Arab countries, and the British ODA channels its resources to Sub-Saharan Africa and South Asia.

[12] AIDSCAP Annual Report, 1995.

3.0 IMPLICATIONS FOR THE FUTURE

Reductions in donor funding for international development activities have made leveraging a key objective for both donors and implementing organizations, who have relied on such leveraging mechanisms as loans, guarantees, equity financing, debt conversions, co-financing, and cost-sharing. These mechanisms are viable and important means to help increase the funding available to achieve key development objectives, but they should not be pursued solely to create financial leverage. Donors and implementing organizations should continue to focus their attention and resources on achieving their overall development aims and should employ these leveraging mechanisms only when they clearly contribute to the realization of those broader objectives.

3.1 FACTORS FOR SUCCESS

In general terms, the ability of various financial mechanisms to generate leverage will depend on the specific circumstances of the project. There are several key factors that will affect the success of any effort to use leveraging mechanisms, and these should be carefully considered by donors and implementing organizations.

Partners: The institutions and organizations involved in developing and implementing the mechanism are critical to the success of any financial leveraging activity. Financial institutions can perform a vital function in expanding access to capital, but they must have sufficient financial incentive to participate. Specialized institutions, such as micro-enterprise funds or venture capital companies, serve specific market niches, and the partners may require technical assistance to effectively implement them in certain environments. An institution's track record, management capabilities, and commitment to a particular development objective must be considered.

Leveraging Potential: The potential for financial gain must be weighed against the risk of losses to the beneficiaries, donors, lenders, or other partners. Changes in a country's economic environment or financial markets can result in decreased demand for certain credit mechanisms or dampen demand among target beneficiaries, thereby affecting the overall effectiveness of a mechanism.

- # **Control:** The use of leveraging mechanisms affects donors' control over a particular project, particularly the use of donor funds and the ability to reach the intended beneficiaries. The extent of donor control varies according to the involvement of certain types of intermediaries, implementing agencies, and host-country organizations. Donors should carefully consider the potential that their control may be limited and should develop appropriate monitoring mechanisms.

- # **Costs:** The costs to donors, lenders, or other financial partners include the transaction costs (the cost of assessing and developing the program), the implementation costs, and the costs of technical assistance or training. These should be realistically estimated and weighed against the potential gains.

- # **Timing:** The time needed to launch a leveraging program and the time that will elapse before any gains are realized will differ considerably by mechanism. Donors should consider the time required to explore and assess an opportunity, negotiate the arrangements with various partners, and disburse the required funds, implement the necessary transactions, and realize the financial gains.

- # **Limitations:** Certain mechanisms are appropriate and effective only under certain conditions. Donors should carefully assess whether the necessary preconditions are met and whether the overall environment is conducive to success.

3.2 STRATEGIES FOR THE FUTURE

Donors contemplating the use of leveraging mechanisms should carefully assess their comparative advantages in light of the specific program objectives. Figure 1 compares the mechanisms surveyed in this paper and outlines some of the factors for success. This matrix underscores some important considerations about the use of some mechanisms:

- # Credit mechanisms, including loans, guarantees, or equity funding, are more appropriate when access to capital is a fundamental requirement for attaining the program's objectives. Many development projects incorporate the use of such credit tools, and they achieve important financial leveraging as a result. However, use of credit mechanisms in health or population programs should be carefully assessed to ensure they it will contribute significantly to the achievement of a given project's fundamental objectives.

- # Using credit mechanisms effectively and efficiently requires extensive organizational infrastructure. Donors should utilize existing organizations as much as possible to minimize the implementation and program costs. The establishment of new organizations adds to the costs and may cause implementation delays that jeopardize the program's ability to achieve its objectives, even financial ones.

- # Guarantees, loans, and equity financing (in that order) generally require relatively lesser amounts of funding to achieve leveraging results. The length of time to produce comparable leveraging results also will generally follow this order.

- # Successful debt conversion programs involve extensive research, negotiation, transaction costs, and time. In addition, the size of the transaction generally must be quite large to yield significant returns. The opportunities to realize sufficient financial gains have been significantly reduced by recent changes in the market for secondary debt. As a result, debt conversion should be pursued only by organizations that have sufficient institutional expertise, resources, and experience.

- # The success of efforts to set up co-financing and cost-sharing arrangements — which are not traditional financial leveraging mechanisms — depends largely on whether the donors and implementing agencies involved are able to coordinate their activities and negotiate suitable arrangements for pooling and sharing their resources.

In sum, leveraging mechanisms should be viewed primarily as tools to achieve broader development objectives. Although their use may be an appropriate and effective means to augment diminishing development funds, they should be used only if they further the overall development objectives of an organization or program. Donors and implementing agencies that consider leveraging their limited funds must assess whether a particular leveraging mechanism is appropriate, whether the potential financial gains outweigh the costs, and whether the effort stands a reasonable chance of success. Fundamentally, however, they must determine whether the use of such mechanisms is the most effective and efficient means to pursue their broader development goals and objectives.

FIGURE 1. A COMPARISON OF LEVERAGING MECHANISMS

Mechanism	Factors for Success					
	Organizational Structure	Leveraging Potential	Control	Costs	Timing	Limitations
Loans	• Banks • Financial institutions • Micro-enterprise funds	• Can achieve 1:1 leverage or more of donor funds • Losses can accrue from non-payment or inflation	• Target right groups of borrowers for impact • Approval criteria • Use of funds by borrowers hard to dictate	• Implementation costs can be high • May require technical assistance and/or training	• May take 1-3 years to revolve funds	• Use of loans implies credit is an appropriate tool for project
Guarantees	• Banks • Financial institutions	•Can achieve from 2:1 to 10:1 leverage over time •Losses can accrue from non-payment or poor portfolio management	• Targeting right groups of borrowers for impact • Approval criteria • Use of funds by borrowers hard to dictate	• Intermediaries absorb implementation costs • Donors need oversight and administration function	• Leverage depends on repayment terms	• Guarantees have to address imperfection in credit markets
Equity	• Venture capital firms • Enterprise funds • Development finance companies	•Difficult to achieve consistent leveraging •High gain and loss potential	• Least control over funding decisions and uses of funds	• Highest operational costs due to nature of projects • Need market and business expertise	• Projects require a long time to pay off	• Difficult mechanism to use in developing economies
Debt Conversion	• Specialized financial brokers • Banks	• Leveraging ranges from 20 percent to 50 percent of transactions in local currency terms	• Uses of proceeds requires local country approval • Can be targeted to specific beneficiaries	• Some brokering costs • Need extensive research, legal arrangements	• May require years to identify and negotiate transactions	• Use of debt conversions has diminished with improvements in LDCs' debt positions
Co-Financing	• Other donors • Financial institutions	• Funding of projects is shared by donors on formal basis	• Coordinating donor funding preferences or constraints	• Administration of funding agreements and trusts	• Funding arrangements may last over project life	• Co-financing is best suited for large projects

Cost-Sharing	• Other donors • Implementing agencies	• Informal sharing of costs by multiple donors	• Coordinating donor funding preferences or constraints	• Implementing agencies need to track costs	• Arrangements need to be structured ahead of time among multiple donors	• Dependent on implementing agencies seeking funding from donors