DEVELOPMENT CREDIT AUTHORITY FEASIBILITY ASSESSMENT

Increasing MSME Access to Private Sector Credit in Malawi

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Delivered under the Deepening Malawi's Microfinance Sector (DMS) Project

Task Order 804 under the Accelerated Microenterprise Advancement Project: Financial Services

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Main Author: Caroline Averch

Submitted by Victor Luboyeski, Chief of Party

vluboyeski@dmsproject.net

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CONTENTS

ACRONYMS

ADB	African Development Bank
BCR	Borrower Cohort Report
BG	Bond Guarantee
COMPASS	Community Partnerships for Sustainable Resource Management in Malawi
DCA	Development Credit Authority
DEMATT	Development of Malawian Enterprises Trust
DMS	Deepening Malawi's Microfinance Sector (Project)
ECLOF	Ecumenical Church Loan Fund
EIB	European Investment Bank
FAO	Food and Agriculture Organization of the United Nations
FINCA	Foundation for International Community Assistance
Fincoop	Finance Cooperative Limited
FITSE	Finance Trust for the Self Employed
FJSTF	Food Joint Security Task Force
FMB	First Merchant Bank
GDA	Global Development Alliance
GOM	Government of Malawi
ICRAS	Inter-Agency Country Risk Assessment System
IFC	International Finance Corporation
LFC	Leasing and Finance Company of Malawi Limited
LG	Loan Guarantee
LPG	Loan Portfolio Guarantee
MARDEF	Malawi Rural Development Fund
MCCCI	Malawi Confederation of Chambers of Commerce and Industry
MRFC	Malawi Rural Finance Company Limited
MSB	Malawi Savings Bank
MSE	Micro and Small Enterprises
MUSCCO	Malawi Union of Savings and Credit Cooperatives
NABW	National Association of Business Women
NASFAM	National Smallholder Farmers' Association of Malawi
NBS	National Building Society
NORSAD	Agency for Joint Cooperation Between 4 Nordic Countries and 11 SADC Countries for SME finance
OIBM	Opportunity International Bank of Malawi
PAMA	Paprika Association of Malawi
PG	Portable Guarantee
PRIDE	Promotion of Rural Initiatives and Development Enterprises
RBM	Reserve Bank of Malawi
RUMARK	Rural Market Development Trust
SACCO	Savings and Credit Cooperative
SEDOM	Small Enterprise Development Organization of Malawi
SO	Strategic Objective
SOW	Scope of Work
T-Bill	Treasury Bill
UNCDF	United Nations Capital Development Fund
USAID	United States Agency for International Development
WARF	Weighted Average Risk Factor

EXECUTIVE SUMMARY

This report describes the context for and feasibility of establishing USAID Development Credit Authority (DCA) guarantee(s) in Malawi to benefit the micro, small, and medium enterprise (MSME) sector. Under the Deepening Malawi's Microfinance Sector (DMS) project, the author examined the existing supply and demand for MSME credit, and identified specific credit market imperfections that constrain MSME access to appropriate commercial financial services.

The report evaluates the interest of Malawi's financial institutions in becoming DCA partner lenders and/or borrowers, as well as their suitability for this role. A number of complementary technical assistance programs that could affect the impact of a DCA guarantee were also evaluated. Additionally, the author interviewed USAID staff, officials of the Government of Malawi, and other donors to review certain aspects of the DCA guarantee design process — such as whether a DCA guarantee would create sufficient "additionality" (additional impact); whether a guarantee might subvert existing private sources of financing; and whether loans to MSMEs would occur without the DCA guarantee.

The basic steps to establish and implement a DCA guarantee are presented within the report, along with design strategies to help the mission develop a guarantee that both supports its strategic objectives (SOs) and has a reasonable subsidy cost. Chapter Six presents a shortlist of promising potential guarantee facilities for fiscal year (FY) 2007 and the medium term, and other applications for DCA guarantees USAID/Malawi can consider should the environment be conducive. The first draft of a concept paper to establish a multi-lender DCA guarantee program in Malawi is appended to the report for the mission's consideration (Annex F).

Key findings of the report are:

1. There is demand among lenders for a partial credit guarantee facility.

2. There is significant unmet demand for credit:
    a. in rural areas
    b. by many MSMEs
    c. in the agriculture sector (non-tobacco)
    d. by MFIs and SACCOs seeking additional loan capital

3. DCA guarantees could be used by USAID/Malawi to increase access to finance for MSMEs with a number of different partner lenders and possible borrowers, augmenting the impact and sustainability of its Economic Growth and Agriculture activities in FY 07 and the medium term.

4. MFIs and NGO MF programs are not ready in (FY) 07 to participate as DCA partner enders or borrowers.

5. A select group of commercial banks and one leasing company may be ready during FY 07 to be partner lenders with loan portfolio guarantees (LPG).

6. There are private sector agribusiness projects seeking to obtain financing that could be supported with DCA loan or portable guarantees, helping the mission to achieve strategic objectives related to food security, in addition to economic growth objectives.

7. Non-USAID donors and international financial institutions (IFIs) are taking a more active interest in supporting access to finance in some sectors. However most of their programs and/or products would not overlap with potential USAID guarantee activities, with the possible exception of IFC MSME Finance credit lines.

CHAPTER ONE: INTRODUCTION

A. ASSESSMENT OBJECTIVE

The principal objective of this assignment under the Deepening Malawi's Microfinance Sector (DMS) project was to determine the feasibility of establishing USAID Development Credit Authority (DCA) guarantee(s) in Malawi for the benefit of the micro, small, and medium enterprise (MSME) sector. The key tasks under this assignment were to:

1. Conduct a credit access assessment in Malawi, draft recommendations, and prioritize a short list of potential partner lenders that a DCA guarantee activity could partner with to expand credit access for MSMEs.

2. Determine the feasibility of establishing DCA activities for the Malawi MSME sector and prepare options and recommendations for USAID/Malawi's consideration.

3. Draft, subject to the outcome of the above, a concept paper for the establishment of a DCA program in Malawi.

Specific activities under the assignment included:

- Meet with potential partner lenders to evaluate the strategies, capacities, and interests of local financial institutions to lend to the MSME sector on a retail or wholesale basis, and to evaluate demand by financial institutions for DCA guarantee products.

- Meet with USAID, other donors, and donor projects as well as government programs to identify those activities that could mutually reinforce and contribute to the success of potential DCA guarantee facilities, or that could potentially limit the impact the DCA guarantee facilities could have.

- Conduct a comprehensive assessment of credit supply for the MSME sector in Malawi, including supply through donor and GOM programs and guarantee facilities, and estimate MSME credit demand by extrapolation from secondary sources and interviews.

- Identify linkages that a DCA guarantee facility could create or enhance in Malawi's MSME sector.

- Provide USAID/Malawi with findings regarding the feasibility of using DCA guarantees, and should it be determined feasible, provide recommendations on different options and practical next steps information.

A complete scope of work can be found in Annex A. It is important to note that this assessment focused on *financial institutions as credit providers* as opposed to informal providers of credit, such as input suppliers or other value chain participants. DCA can work with non-financial institution providers of credit as partner lenders; however, they must have a separate credit division within their other operations that can be thoroughly analyzed during the due diligence process.

This report summarizes key findings from the assessment related to existing MSME credit supply and demand, and specific credit market imperfections constraining MSME access to private sector credit. The report presents DCA as one of USAID's options to increase private sector investment in development activities; some of the potential DCA guarantee facilities that might be considered by USAID/Malawi for fiscal year (FY) 2007 as well as the longer term are described. Additionally the report discusses some of the specific design elements that the mission should consider in tailoring any DCA guarantees to complement existing and planned strategic objectives, and it reviews steps the mission would need to undertake should it choose to move forward in developing any DCA guarantees.

B. RESEARCH

The author reviewed relevant secondary source material to obtain background information and context for the feasibility assessment. In Malawi, interviews were conducted with the following types of entities to collect information about credit supply and demand for MSMEs and evaluating the feasibility of a USAID/Malawi DCA guarantee program:

- Commercial banks
- Microfinance companies
- NGO micro credit providers
- Other non-bank financial institutions and financial sector actors
- GOM ministries
- GOM MSME programs
- Donors and donor projects
- International financial institutions (IFIs)
- Business associations

A subset of the credit providers interviewed completed a survey, summary data from which is Included in Chapter Four. A complete list of interviewees can be found in Annex B.

C. CONTEXT FOR EVALUATING DCA FEASIBILITY

This section of the report describes the broad context in which this feasibility assessment occurred. All macroeconomic factors as well as technical support programs mentioned below would be analyzed more thoroughly as part of the design and development process for any DCA guarantees the mission may wish to pursue, as described in Chapter Four.

C1. USAID/MALAWI

DCA guarantees must support and be integrated into existing USAID mission or other operating unit objectives, rather than a separate strategic objective (SO) being created for DCA activities specifically. USAID/Malawi has been supporting the development of micro, small, and medium-sized enterprises through multiple programs under its SO to increase rural incomes. Projects under this SO range from support for bank and non-bank financial institutions focusing on MSME finance, to improving the business enabling environment, to support of smallholder farmer associations and the development of particular agricultural subsectors — such as dairy and natural resource based products — to food security and watershed protection.

Many of USAID/Malawi's activities have ended or are ending in 2006, and the mission is now at an interesting juncture as it prepares a new Country Operating Plan with assistance from USAID/Washington under the new USAID framework. USAID/Malawi has been actively coordinating with other donor efforts such as the Food and Agriculture Organization of the United Nations (FAO)'s work on cassava and dairy sector development, and the World Bank's initiatives to improve the institutional infrastructure for warehouse receipts. It is possible that some of the complementary technical assistance and policy reform activities that may be required to improve the enabling environment and/or to boost capacity for potential borrowers under a DCA guarantee could be provided through coordination with one of these programs.

USAID/Malawi's budget has been steadily decreasing over the past few years, but the mission has been very innovative in leveraging private sector resources and expertise through a series of Global Development Alliance (GDA) partnerships. These augment and create a sustainability strategy for USAID activities in watershed and park management, community development, food security, and trade development. Like GDA, DCA leverages significant amounts of private sector resources and promotes an exit strategy by giving private sector lenders an incentive to invest in creditworthy enterprises and projects, rather than depend on a grant from USAID.

C2. TREASURY BILL RATES

As discussed in the 2004 Microfinance Sector Assessment[1] the increasing spread between the weighted average yield on Government of Malawi (GOM) Treasury Bills (T-bill) and the Reserve Bank of Malawi Base Rate has caused banks and other financial institutions to find it more profitable and less risky to purchase T-bills than to lend to businesses. Compounding the financial disincentive to lend to businesses faced by financial institutions, "many prospective borrowers were driven from the credit market when returns on business opportunities were inadequate to service the high interest charged on loans."[2]

From 2004 to the current period, the GOM has been able to address the need to pay off a portion of its domestic debt and to cut spending, causing the T-bill rate to decrease from 44.27 percent in June 2002 to 19.5 percent in June 2006. The decreasing margin on T-bill investments has somewhat reinvigorated the interest of financial institutions in exploring lending opportunities to

[1] Luboyeski, et. al., Microfinance Sector Assessment in the Republic of Malawi, AMAP Microfinance IQC Chemonics Consortium, January 2004.
[2] Ibid.

businesses and projects as they plan to diversify their income streams. This characteristic in the financial sector historically has contributed to a receptive environment for DCA guarantee facilities across the global DCA portfolio, as high returns on T-bills make it difficult to convince lenders to accept credit risk from target borrowers under guarantees.

C3. EXCESS LIQUIDITY

One of the core principles of DCA is to harness excess liquidity in developing countries and help lenders direct funding towards productive investments in enterprises and projects that are traditionally underserved by the financial sector.

The Reserve Bank of Malawi (RBM) website does not specify the level of liquidity that commercial banks are required to maintain to be in compliance with the Banking Act of 1999, under which commercial banks are supervised and regulated. However in response to a DMS inquiry, the RBM stated that commercial banks must maintain a 20 percent liquidity reserve requirement against deposit balances.

Various commercial banks that contributed to this assessment stated that the RBM required them to keep liquid up to 27 percent of their deposit balances; many keep liquid a significantly higher percentage. This supports the general assumption in the market that there is significant excess liquidity in the banking sector that could be directed at productive investments that would support USAID and Government of Malawi objectives.

C4. GOVERNMENT POLICIES

Over the past decade the GOM has initiated certain policies, and influenced the behavior of government-owned institutions so as to impact the overall credit environment, in particular credit for agriculture. Some of these policies and behaviors might impact the effectiveness of any proposed DCA guarantee facilities in terms of the rate of interest charged on loans to targeted borrowers, or sectors that could stifle demand for market rate loans made under a DCA program.

Historically, GOM-directed loan programs through publicly owned entities have made loans that were not issued, monitored, or collected according to best practices, thereby generating significant loan default rates, and contributing to what Malawian lenders refer to as a culture of non-repayment. Most recently on credit supply side interventions, the GOM established the Malawi Rural Development Fund (MARDEF) to provide up to Malawi Kwacha (MK) 5 billion (USD 38,835,684)[3] to MSMEs targeted by districts at interest rates below half the prevailing market rate discussed in Chapter Four.

The GOM also recently announced that there would be a fixed ceiling on prices for each grade of tobacco on the auction floor, which surprised producers and major buyers. Concern has been expressed that the GOM might intervene on pricing in other sectors. Pricing has a direct impact on the financial viability and creditworthiness of potential borrowers, as well as the perceived and real risk faced by lenders in extending them credit, hence affecting lending under any proposed DCA guarantees.

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[3] Exchange rates were calculated at MK 1 = USD .008 / USD 1 = MK 136.58.

CHAPTER TWO: USAID DCA PARTIAL CREDIT GUARANTEES

A. CREDIT ENHANCEMENTS

In broad terms, a credit enhancement is any type of instrument or process that mitigates credit risk, provides a lender assurance that it will be compensated if the borrower defaults or is delinquent in repayments, or improves a credit rating (in the case of bond issues). Credit enhancements can take the form of collateral, insurance, escrow accounts, a letter of credit, assignment of revenues, third-party guarantees, or other types of agreements. Donors and governments use credit enhancements, typically in the form of guarantees, to induce the private sector to lend to a particular sector or group of borrowers.

A1. DCA OVERVIEW

USAID's Development Credit Authority is a financial tool used to leverage limited donor funds and build local private-sector financial institutions in developing countries. DCA is one of USAID's many Global Development Alliance models for forming public-private partnerships, and it is being used to support beneficiaries of many USAID projects.

DCA mobilizes local capital and encourages private financial institutions to provide longer-term credit, reduce inappropriate collateral requirements, offer market-based interest rates, and invest in local development efforts in lieu of or in addition to USAID and other donors. It enhances impact and sustainability, as private lenders often continue lending to the target borrowers long after the guarantee expires. As more lenders enter the market, increased competition leads to better terms and interest rates for borrowers, and lenders' capacity to properly evaluate the creditworthiness of borrowers improves over time.

A Symbiotic Partnership

Engaging local financial institutions with DCA guarantees creates benefits for all parties:

Credit Access. Borrowers gain increased access to capital to expand their economic opportunities.

Risk Sharing. Private lenders put their own capital at risk, and use their human and other resources—credit expertise, infrastructure, and sector knowledge—to stimulate economic growth.

Lenders Expand. Lenders gain safer entry into new, potentially profitable markets.

Demonstration Effect. Successful DCA activities produce a powerful demonstration effect, with a lender's visible success encouraging other lenders to enter similar markets previously perceived as too risky.

Sustainability. USAID gains critical progress in creating sustainable financing sources for development activities.

A2. BENEFITS OF DCA

DCA gives USAID the flexibility to use credit assistance in lieu of or in combination with grant assistance by offering partial credit guarantees to private sector lenders. DCA is used to facilitate access to credit for financially viable and creditworthy enterprises and projects in areas or sectors traditionally underserved by the financial sector because lenders perceive high risks.

DCA agreements cover up to 50 percent of a lender's risk, encouraging private commercial banks and other private lenders to lend their own capital to enterprises and projects in non-traditional and unfamiliar sectors. It is an ideal tool to help lenders overcome perceived risks of loan default and to improve their credit assessments.

DCA gives USAID tremendous budget leverage, with the actual cost to missions averaging 3 to 9 cents for every dollar lent by a private bank or non-bank financial institution. The initiating USAID mission, bureau, or office pays the U.S. Treasury a subsidy cost, calculated as a percentage (approximately 3-9 percent) of the value of the guarantee facility. The lender also pays fees to enjoy the coverage, reducing the amount paid by USAID. USAID can use a small portion of its budget for a guarantee, and more effectively use grant and technical assistance funds for capacity building and other valuable non-revenue generating activities.

How Much Does DCA Cost the Mission?

A $10,000,000 DCA guarantee facility could cost $400,000, equal to 4% of the guarantee amount. For each $1 spent by USAID in this scenario, $25 of private sector money would be lent for development projects.

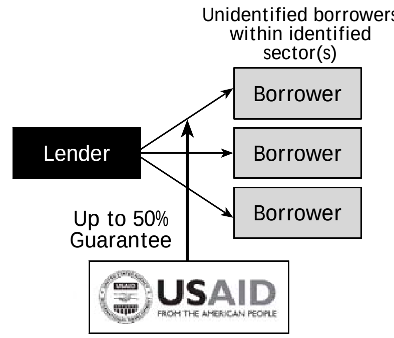
DCA has some very specific precepts differing from other USAID mechanisms and other donor approaches that are important to consider within a given country context. These rules include:

1. **Additionality.** DCA guarantees must not be used unless it is probable that the loan or group of loans would not be made without it, taking into consideration whether such financing is available for the term needed and at a reasonable cost.
2. **Financial Viability.** Each activity funded under DCA guarantees, such as loans to MSMEs, must be financially viable (i.e. sufficient cash flows to meet all operational costs and service all the debt).
3. **Market interest rates.** DCA guarantees allow a lender to determine a market interest rate that it will charge borrower(s) under a guarantee so as not to distort the interest rate environment.
4. **Currency matching.** Revenues generated by DCA-supported activities should match the currency of a borrower's debt obligations.
5. **Pari passu risk sharing.** USAID covers no more than 50 percent of a lender's risk, in order to leverage private sector resources and reduce moral hazard or reckless conduct due to the fact that the guarantee is in place.

B. DCA GUARANTEE PRODUCTS

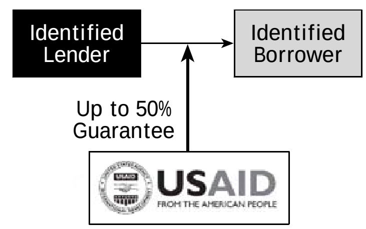
DCA can be structured to enhance credit in a variety of situations, supporting different USAID objectives. All DCA guarantee products help demonstrate to the market that a borrower or group of potential borrowers is creditworthy, and present a profitable long-term business opportunity to private lenders. USAID's basic DCA guarantee products include: a) loan portfolio guarantee; b) loan guarantee; c) portable guarantee; and d) bond guarantee; these are described briefly below. *All DCA guarantee products were considered for the purposes of this feasibility assessment with the exception of a bond guarantee, as this was determined to be premature for the Malawian market.*

B1. LOAN PORTFOLIO GUARANTEE



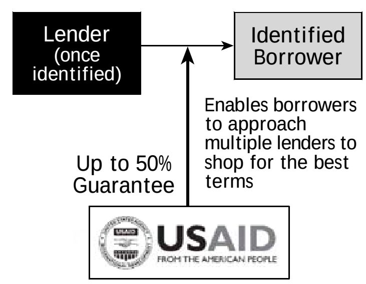
DCA loan portfolio guarantees (LPGs) provide a guarantee of up to 50 percent to an identified lender's portfolio of multiple loans to borrowers in a predetermined sector. LPGs are typically used to directly stimulate access to credit for underserved market segments, reduce onerous borrower collateral requirements, and stimulate competition among lenders. LPGs can also help reduce interest rates in the longer term. USAID has used LPGs to stimulate lending to borrowers including SMEs, agribusinesses, post-secondary students, clean energy projects, and low-income home buyers, among others.

B2. LOAN GUARANTEE



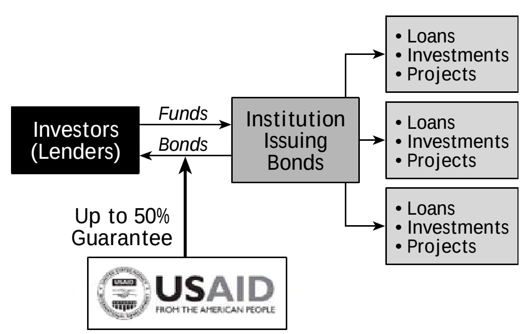
A loan guarantee (LG) offers a guarantee of up to 50 percent to facilitate a loan between an identified lender and an identified borrower. USAID has used LGs to cover partial risk on loans from larger financial institutions to smaller financial institutions such as MFIs, which use the capital for on-lending to a group of target borrowers, and to support housing finance.

B3. PORTABLE GUARANTEE



Portable guarantees (PGs), also known as portable letters of commitment, guarantee a loan to an identified borrower from an unidentified lender. With the portable guarantee, the onus is on the borrower to "shop around" among multiple lenders meeting minimum criteria to negotiate the best terms, and the selected lender receives a guarantee of up to 50 percent on that loan. One of the additional benefits of using the PG product instead of the LG product described above is that the borrower not only has access to credit, but also builds the capacity to present a bankable profile and negotiate with commercial lenders. USAID has often used PGs to guarantee wholesale loans from larger financial institutions to smaller financial institutions such as MFIs, which use the capital for on-lending to a group of target borrowers.

B4. BOND GUARANTEE



DCA bond guarantees (BGs) are used to partially guarantee investors' risk in purchasing bonds, notes, securities, or any other type of debt instrument standard in the country of issuance. Funds raised through bonds guaranteed up to 50 percent by BGs help sustainably extend the term of domestic credit available for longer-term projects, such as infrastructure, and strengthen capital markets. Bond guarantees have been used to extend the term of credit available for municipal infrastructure, water, and small-scale energy projects requiring medium to long-term investment.

C. DCA GLOBAL LESSONS LEARNED AND BEST PRACTICES

Six years of global and regional DCA application have yielded a number of lessons that should be integrated into any approach to a DCA guarantee facility that USAID/Malawi may take. This subsection presents a summary of experiences that are applicable to DCA guarantees in any sector, with a focus on loan portfolio guarantees, loan guarantees, and portable guarantees.

C1. GUARANTEE DESIGN AND DEVELOPMENT BEST PRACTICES

Choose lenders who will be strategic partners. Guarantees are typically more effective in terms of utilization, demonstration effect, and sustainability if the lender has a strategic and compatible interest in the target market that USAID is trying to assist. The biggest and best known lenders do not always make the best partners for a guarantee. It is advisable to identify which institution, in a pool of strong lenders, might be the most aggressive about moving into a niche business area in advance of competition. There must also be a strong commitment from the lending institution's senior management to ensure that sufficient resources and attention are made available. There may also be factors internal to the lender that should be taken into consideration when planning the timing of a DCA intervention, such as fiscal cycles, launch of a new tailored credit product, a key training event for credit staff, or changes in management.

Combine lending with capacity building to ensure results. The most successful DCA activities are paired with and reinforce existing capacity building and policy reform initiatives undertaken by USAID or other donor projects or local educational institutions and NGOs. Targeted capacity building for both lenders and potential borrowers has proven to be valuable in ensuring effective utilization of guarantees. The most appropriate capacity building activities for potential borrowers include assistance in identifying projects, developing business plans, preparing loan applications, and increasing management skills. Constructive assistance to lenders includes building capacity in credit analysis, cash flow lending, and new product development.

Define qualifying borrowers broadly. Under a loan portfolio guarantee, it is typically better to keep the definition of qualifying borrowers broad rather than prescriptive to encourage extensive use of the guarantee facility. For example, a legal agreement with a lender could include the following broad terminology: "viable projects for any business with up to 50 employees," or "municipalities with viable water, energy, or infrastructure projects." The reason for this latitude is that each participating bank will typically select a particular niche or market segment in which to specialize and target their lending. An attraction to lenders receiving the guarantee is the ability to test the waters to determine which clients best fit their strategy, and defining qualifying borrowers broadly facilitates outreach to different clients.

Take a private sector approach. During the negotiation process for the guarantee, it is advisable to illustrate the bottom-line benefits to lenders by presenting a few illustrative projects and their financials. Based on the soundness of potential projects and other considerations, lenders may be willing to accept less than the maximum 50 percent guarantee coverage allowable under DCA and/or pay higher fees for guarantee coverage to mitigate the risk of their loan portfolio. Therefore it is usually possible to start negotiations with an offer of less than 50 percent coverage and at the higher end of the fee spectrum, both of which would reduce the subsidy cost paid by the mission.

C2. BEST PRACTCES IN IMPLEMENTATION

Manage the lender relationship. During the implementation phase of a loan portfolio guarantee, ongoing lender relationship management is key to ensuring use of the guarantee and timely reporting by the lender — both critical elements of a successful DCA guarantee. USAID missions that do not have sufficient staff to handle such activities typically delegate LPG monitoring and reporting responsibilities to relevant implementation partners with a strong understanding of local market conditions, as well as technical and financial expertise. Likewise, for LGs and PGs, ongoing relationship management with the borrower (i.e. a smaller financial institution or a private sector agro-processing project) and some level of capacity building may be needed to ensure the success of the project. An example of this might be training for a smaller financial institution on problem loan collection or coordination with an agricultural development project to ensure an agro-processing project has sufficient supply.

Expect differing utilization patterns. In general the following trends in loan portfolio guarantee lending under coverage, or use of a guarantee facility, have been noted:

- Large commercial banks and very small financial institutions tend to begin utilization slowly.
- Mid-size commercial banks, MFIs (of all sizes), and mid-size financial institutions tend to utilize faster.
- When the guarantee is meant to help a financial institution develop a new loan product, it tends to take longer than when simply modifying existing underwriting methodologies.

Respond quickly to potential claims. During the life of the guarantee, it is possible that lenders will experience some loan defaults and plan to submit claims after reasonable recovery efforts, which is part of the learning process DCA is intended to foster. Through ongoing lender relationship management, it may be possible to mitigate the size of the claim if the lender addresses the problem loan(s) early, possibly with support from the guarantee implementer or another relevant technical assistance project. In such cases, immediate follow up by the guarantee implementer is required to determine the causes of the problem, the expected amount of the potential claim, and to work with the lender on steps to limit further claims.

D. DCA PARTNER LENDERS

A number of potential partner lenders that could be considered for any future guarantee facilities in Malawi were interviewed for this assessment. The author met with commercial banks, a leasing company, savings and credit cooperatives, microfinance companies, and NGO micro-credit providers; a complete list of interviewed institutions is presented in Annex B. This subsection of the report presents criteria for DCA partner lenders to provide context for the recommendations presented in Chapter Six.

DCA facilitates credit in a broad variety of situations and environments for a large range of projects and enterprises. DCA partner lenders can include privately owned:

- Commercial banks
- Mortgage finance companies
- Microfinance institutions
- Leasing companies
- Other non-bank financial institutions
- Investment funds
- Pension funds
- Insurance companies
- Suppliers or other value chain actors offering credit through a financial arm
- Bond investors

Ideal DCA partner lenders should be privately owned, solvent, and have a branch network or other means of geographic coverage conducive to financing the types of enterprises or projects intended under the guarantee. Partner lenders must also be able to demonstrate reasonably strong and improving credit policies and procedures, credit analysis techniques, and risk management. DCA partner banks must be transparent, both in their financial statements and audit reports, and must disclose their ownership and conflicts of interest. Partner lenders for LPGs must have, or be able to access, sufficient funds for lending to the targeted borrower group. And, as mentioned above, it is advisable to select lenders with a long-term strategic interest in the target sector to support sustainability.

CAMELS

CAMELS is the assessment method used by US bank regulators and evaluates the following areas of a financial institution:

C – Capital Adequacy
A – Asset Quality
M – Management
E – Earnings
L – Liquidity
S – Sensitivity to Market Risks

In order to ensure lenders are transparent and to evaluate their overall strength, DCA requires that partner lenders for LPGs and LGs be rated by an international ratings agency. For commercial banks, ratings such as those provided by Standard & Poors or Moody's would be accepted. For non-bank financial institutions (NBFIs), commonly used rating methodologies are accepted, such as MicroRate and PlanetRating for MFIs, and PEARLS for credit unions. If a lender does not have a rating, this due diligence process becomes part of the risk assessment process conducted by USAID's Office of Development Credit (ODC). Commercial banks without ratings must undergo a CAMELS analysis (see textbox), and other types of institutions are analyzed using methodologies such as those mentioned above. PGs are usually structured so that a borrower with a USAID DCA portable letter of commitment can select any lender (typically commercial banks) meeting certain minimum rating criteria. However, if the selected lender under a PG or LG does not have a rating, it is probable that USAID/ODC would need to evaluate it through a CAMELS analysis.

A preliminary assessment of lenders that may be suitable and interested in becoming DCA partner lenders was completed for this report, but no due diligence was performed. With the exception of the South African-affiliated banks, none of the commercial banks interviewed have a rating, nor do any of the MFIs, NGO credit providers, or non-bank financial institutions interviewed.

Therefore, with the exception of the South African banks operating in Malawi, all lenders would need to have either a CAMELS or similar due diligence exercise completed by the ODC risk assessment team, and USAID/Malawi would need to build this into its timing and phasing for DCA guarantee design and development.

CHAPTER THREE: MSME CREDIT SUPPLY AND DEMAND

A. APPROACH AND METHODOLOGY

DCA guarantees may only be used to redress credit market imperfections that prevent creditworthy borrowers from accessing credit as they would in a more developed financial sector. Identifying gaps in credit supply and demand is the first step in overcoming these credit market imperfections. Since a complete statistical survey was beyond the scope of this assessment, a less formal methodology was used to collect sufficient credit supply and demand information to identify specific areas of unmet credit demand.

Information was collected through interviews with private and public sector providers of credit, yielding a preliminary estimate of the amount, type, and terms of credit being supplied in Malawi to MSMEs. Additionally, each lender answered survey questions about specific constraints faced in lending to MSMEs; outreach and coverage in certain geographic areas; portfolio quality; involvement with donor or government programs; and other facts about the lender.

Collecting credit demand information was a more complicated task. A follow-up to the MSE Baseline Survey completed in 2000[4] was beyond the scope of this assessment; therefore, part of the lender survey was adapted to collect information on the demand for credit by potential loan clients that were rejected by financial institutions as a proxy for a more comprehensive credit demand study. This worked to some extent, although the responses were incomplete since many lenders do not track loan applicants who requested financing but in the end were not provided with loans. However, information collected this way was positively correlated with information provided by associations, such as NASFAM, and also were consistent with data from other sources including the AMAP Microfinance Assessment and the 2000 GEMINI Baseline Survey. The templates for both portions of the survey administered to various types of lenders can be found in Annex C.

B. CREDIT SUPPLY

Private and public suppliers of credit are differentiated in this report, since DCA guarantees are intended to be used with private sector lenders for the purpose of providing credit to private and sub-sovereign entities (including municipalities). The Office of Development Credit will consider working with partner lenders with partial sovereign ownership of less than 50%, but it strongly prefers that lenders be owned by private sector entities. Although only private sector lenders were considered as potential DCA partner lenders, public sector lenders were included in the assessment to evaluate the total supply of credit and existing gaps. For the purposes of this report, ownership and registration under Malawian law are the key criteria in classifying financial institutions as belonging to the private or public sector.

B1. PRIVATE SECTOR CREDIT SUPPLY

In the private provider of credit category, interviews were conducted with and surveys were provided to:

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[4] USAID MSE Baseline Survey in Malawi, 2000.

- Seven commercial banks
- Two officially registered microfinance companies
- Three nongovernmental (NGO) microcredit providers (herein referred to as MFIs)
- Four non-bank financial institutions (NBFIs)

The findings from these interviews and surveys are presented below.

B2. COMMERCIAL BANKS

Private sector commercial banks interviewed and provided with the two-part survey included:

1. First Merchant Bank (FMB)
2. Indebank
3. Loita Investment Bank
4. National Bank
5. National Building Society (NBS) Bank
6. Nedbank
7. Opportunity International Bank of Malawi (OIBM)

Table 3-1 below presents comparative credit supply data from the commercial banks completing the survey, including size of the banks' MSME portfolios in terms of number and value of loans; and type and terms of credit products for MSMEs currently offered, including loan size range, maturities, and interest rates. A description of each of the banks focused on their interest in and suitability to become DCA partner lenders is presented in Chapter Seven.

MSME Portfolio. Commercial banks do not use a standard definition of MSME, but it is evident — when one compares the figures for number of MSME loans from OIBM (6,891 clients) to the rest of the commercial banks with an average of 58 clients — that the majority of the banks are just moving into the MSME market and few directly serve microenterprises as shown by average loan size. An estimated 7,239 MSME clients are being served by commercial banks. In terms of total portfolio size by loan value, the four commercial banks, including OIBM for which data is available, show MK 1.34 billion (USD 10,407,963) currently outstanding to individual MSMEs (MK 50 million, or USD 388,357 of FMB's reported MK 60 million, or USD 466,028 is a fully guaranteed wholesale loan to an MFI).

Loan Size. It is important to note that the range of loans considered by the majority of commercial banks and NBFIs to be their "micro-loan" portfolio would be considered SME loans by OIBM. For instance, FMB has a minimum loan size of MK 100,000 (USD 777) compared to the minimum for OIBM's microloan, which is 5,000 (USD 39) since they are targeting different markets. Across FMB, Indebank, and Nedbank, the average MSME loan size is MK 216,600 (USD 1,682). By comparison OIBM splits the MSME market and differentiates the types of products offered so that its microloan average size is MK 15,500 (USD 120) and the SME loan average is MK 750,000 (USD 5,825).

Term. Loan maturities offered by the commercial banks ranged from short working capital loans, often structured as overdraft facilities with a maximum maturity of 12 months; to 36 months for the SME capital expenditure loans. While OIBM focuses on much smaller sized enterprises as their client base, the maturities of OIBM's microloan product, ranging from 12 months maximum maturity, and its SME loan product with a 36-month maximum maturity, reflect the terms of the other banks for SME loans. NBS Bank mentioned that it has 60-month terms but that was only for the lease-back product for which the bank retains title to the asset. National Bank mentioned that it could go up to 10 years for capital expenditure loans, but it is assumed that this is for larger corporate lending and probably not offered frequently. During interviews many of the banks stated that the maximum maturity was not always provided to clients because of concerns about general economic stability.

Interest rate. Effective interest rates (including fees) for local currency loans provided by commercial banks to MSMEs were almost exactly the same at 34 percent per annum, based on the current RBM rate of 27 percent. However, one can see the difference in the interest rate on loans to SMEs versus microenterprises by examining OIBM, which provides microloans at 4.35 percent per month that translate over a 12 month period into 52 percent depending on the calculation method and the fees collected. This higher rate represents the higher cost of outreach, loan processing, monitoring, and collections on microloans.

B3. MICROFINANCE COMPANIES AND NGO MICRO CREDIT PROGRAMS

Private sector microfinance institutions interviewed and provided with the two-part survey included:

1. Ecumenical Church Loan Fund (ECLOF)
2. FINCA Malawi
3. Finance Trust for the Self Employed (FITSE)
4. National Association of Business Women (NABW)
5. PRIDE Malawi

Table 3-2 presents comparative MSME credit supply data from MFIs, including size of the MFI's MSME portfolio in terms of number and value of loans. It also includes the type and terms of credit products for MSMEs available, including loan size range, maturities, and interest rates. A description of each of the MFIs focused on their interest and suitability as potential DCA partner lenders is presented in Chapter Seven.

Outstanding Portfolio. All combined, the microenterprise lenders had an outstanding portfolio of approximately MK 394.4 million (USD 3,063,358) across 38,569 loans, some of which were loans to groups comprising anywhere from 4 to 20 people. It is notable that all of the institutions with the exception of PRIDE Malawi are dealing with significant portfolio quality problems at the present time.

Loan Size. Minimum loan sizes provided by the MFIs to both individuals and groups ranged from MK 10,000 to MK 150,000 (USD 78 to 1,165), with maximums between MK 80,000 and 1.5 million (USD 621 to 11,651). NABW's maize mill loans for rural women's groups are an outlier at MK 400,000 to 500,000 (USD 3,107 to 3,884) with a longer term for payoff. ECLOF's much larger institutional loans are also outliers since they are intended for churches to undertake building or community projects.

Term. ECLOF's institutional loans were the only loans with a maturity up to 48 months since they are for building or longer term projects. The longest maturity across the MFIs is 24 months, with the minimum being 3 months.

Interest rate. This survey showed a wide variety of interest rates, since some of the institutions are aiming for financial self-sufficiency while others are not. Interest rates ranged from prime rate minus 5 percent to more than 66 percent per annum, with the lower interest rates being charged by those institutions not targeting sustainability.

Diversity of credit products. With the exception of the maize mill loans, only a few products were found in this collection of MFIs: group loans, and in some cases, individual business loans.

B4. NON-BANK FINANCIAL INSTITUTIONS

Private sector non-bank financial institutions interviewed and provided with the survey included:

1. Finance Cooperative Limited (Fincoop)
2. Indefund
3. The Leasing and Finance Company of Malawi Limited (LFC)
4. Malawi Union of Savings and Credit Cooperatives (MUSCCO)

Table 3-3 presents comparative MSME credit supply data from these NBFIs, including size of the MSME portfolio in terms of number and value of loans, and the type and terms of credit products for MSMEs available including loan size range, maturities, and interest rates. A description of each of the NBFIs focused on their interest and suitability as potential DCA partner lenders is presented in Chapter Seven.

Leasing and Finance Company. LFC, wholly owned by FMB, states that it is the only stand alone, separately registered leasing company that is not within a commercial bank in Malawi. Benefits of this status include that it is not subject to the same reserve requirements as commercial banks, and can therefore leverage its capital more effectively. LFC currently has 420 accounts, many of which are MSMEs, worth a total of MK 650 million (USD 5,048,639), with MK 2.5 million (USD 19,418) the average transaction size. LFC has a wide range of products including all types of leasing arrangements – standard financial and operating leases, as well as lease back – in addition to some limited business lending to well known customers. Because LFC retains title of the asset, it can offer maturities of up to 60 months for around the same interest rates as the commercial banks at between 31and 33 percent.

SACCOs/MUSCCO. Only one SACCO was interviewed as part of this assessment, which offered group and individual business loans, agricultural loans, and consumer finance. Loan size is always based on the amount on deposit at the SACCO, but the maturity can only extend to 10 months for any type of credit product. The average loan size at the FINCOOP SACCO is MK 12,800 (USD 99) and it currently has a portfolio of MK 12.3 million (USD 95,536). FINCOOP is currently borrowing from MUSCCO, the SACCO apex institution, at 27 percent and charging its members 27+1 percent. MUSCCO's portfolio consists of 11 loans to SACCOs worth MK 72.2 million (USD 559,234) with a term of between 6 and 12 months. MUSCCO stated in its survey that it is constrained by lack of access to capital for lending to SACCOs for on-lending. However it should also be pointed out that MUSCCO also invests some SACCO savings that it manages in T-bills, and several SACCOs maintain large saving balances from their excess liquidity in commercial banks. This discrepancy deserves further research, and more information may become available through the SACCO ratings activity the DMS project is undertaking in Quarter 3 of 2006.

Indefund. Indefund is able to provide loans and equity to SMEs, with loans ranging from MK 500,000 to 2 million (USD 3,884 to 15,534). It lists 165 cumulative loans worth MK 148.8 million (USD 1,155,750) with terms between 12 and 36 months. Indefund's interest rate is higher than most between 33.75 and 35 percent — perhaps this is to cover higher loan loss reserves, with a non-performing loan figure of 26 percent.

Table 3-1. Credit Supply by Private Sector Commercial Banks

	First Merchant Bank (FMB)	Indebank	Loita Investment Bank	National Bank	New Building Society (NBS) Bank	Nedbank	Opportunity International Bank of Malawi (OIBM)
MSME definition (if applicable)	Loans between MK 100,000 – 250,000 (USD 777 – 1,942)	N/A	N/A	N/A	*Currently retail bank	Small scale businesses, e.g. sole proprietorships, partnerships	N/A
MSME credit products available	Working capital (overdrafts and loans)	Working capital loans for SMEs	Trade finance for larger SMEs	Overdrafts Capital Exp. Loans Leases thru Asset Finance division	N/A	No products specific for this sector	Indiv. Small and Med. Bus. Loans Corporate Group and indiv. Microloans
MSME portfolio outstanding (# of loans)	95	52	N/A	N/A	N/A	28	6,891
MSME portfolio size outstanding (value of loans)	MK 60 million (USD 466,028) of which 50 million (USD 388,357) is to one MFI	MK 860 million (USD 6,679,738)	N/A	N/A	N/A	MK 6.3 million (USD 48,933)	MK 467 million (USD 3,627,253)
NPL in MSME portfolio	.0002%	4%	N/A	5%	N/A	0.2%	3.05%
MSME minimum loan size	MK 100,000 (USD 777)	N/A	N/A	N/A	N/A	N/A – no products specific for this sector	MK 5,000 (USD 39)
MSME maximum loan size	MK 250,000 (USD 1,942)	N/A	N/A	N/A	N/A	N/A – see above	MK 80 million (USD 621,371)
MSME average loan size	MK 150,000 (USD (1,165)	MK 100,000 – 500,000 (USD 777 – 3,884)	N/A	N/A	N/A	MK 200,000 (USD 1,553)	Micro: MK 15,500 (USD 120) SME: MK 750,000 (USD 5,825)
MSME loan term minimum	12 months	8 months	N/A	N/A	N/A	N/A	Micro: 4 months SME: N/A
MSME loan term maximum	24 months	36 months	N/A	O/D: 12 months Cap Exp: 10 years	Loans and lease backs: 60 months	12 months	Micro: 12 months SME: 36 months
MSME loan interest rate	32% (+2% in fees)	N/A	N/A	N/A	N/A	32% (+1.5-2% fees)	Micro: 4.35% per month (+2.5% fees) SME: 33% (+ 1-1.5% fees)

Table 3-2: Credit Supply by Private Sector Microfinance Companies and NGO Credit Providers

	ECLOF Malawi	FINCA Malawi	FITSE	NABW	Pride Malawi
Outstanding portfolio (number of loans)	2184	16,000	13,340	168 (=25 groups)	6,877
Size of outstanding portfolio (value of loans)	MK 52 million (USD 403,891)	MK 173 million (USD 1,343,715)	USD 0.9 million	MK 2.5 million (USD 19,418)	MK 166 million (USD 1,289,345)
Portfolio at Risk > 30 days	MK 45 million (USD 349,521) principal over 31 days due MK 18 million (USD 139,808) interest over 31 days due	15%	8.7%	20%	3.9%
Credit Products Available	Community solidarity Group Loan (groups of 5-10); Small-scale Project Loans; Institutional Loan- to churches or community organizations	Group loans Individual loans	Business Loans Agricultural Loans	Group lending (groups = 5-8 people) Maize mill loans	Mpamba Loan; Napwepwete Loan; Consumer Loan; Nsodzi Loan; Tiyi Loan and; Thonje Loan
Minimum loan size	CSG Loans- MK15, 000 (USD 117) SSP Loans - MK150,000 (USD 1,165) Institutional Loans – MK 7M (USD 54,370)	MK 100,000 (USD 777) per individual per group	MK 4780.30 (USD 35)	Group: MK 10,000 (USD 78) Maize mill: MK 400,000 (USD 3,107)	MK10,000 (USD 78)
Maximum loan size	CSG Loans - MK 150,000 (USD 1,165) SSP Loans - MK1.5M (USD 11,651)	MK 400,000 (USD 3,107) per individual per group	MK 976,547 (USD 7,150)	Group: MK 80,000 (USD 621) Maize mill: MK 500,000 (USD 3,884)	MK 1 million (USD 7,767)
Average loan size	CSG Loans- MK 75, 000 (USD 583); SSP Loans- MK 825, 000 (USD 6,408) Institutional Loans- K4.25M (USD 33,010)	N/A	MK 10,380 (USD 76)	MK 15,000 (USD 117)	MK 13,000 (USD 101)
Loan term minimum	CSG loans: 4 months Small biz loans: 6-18 months Institutional: 12-48 months	4 months	3 months	Group 6 months	4 months
Loan term maximum	CSG loans: 12 months Small biz loans: 18 months Institutional: 48 months	12 months – group 24 months - individual	12 months	Group: 18 months Maize Mill: 24 months	12 months
Loan interest rate	30% per annum calculated flat for groups and small business, Declining for institutional loans	First round – 5% per month flat Second round - 3.5% per month flat	66%	5% below market rate (EU funded) 30% (British HC funded) 35% first time borrower	36%

Table 3-3: Credit Supply by Private Sector Non-Bank Financial Institutions (NBFIs)

	Finance Cooperative Limited (FIncoop)	Indefund Limited	The Leasing and Finance Company of Malawi Limited (LFC)	Malawi Union of Savings and Credit Cooperatives (MUSCCO)
MSME definition (if applicable)	N/A	Target “smaller” clients	Considers existing portfolio to be “SME”	N/A
MSME credit products available	Business Loans –(Individual or Group) Agricultural Loans (Individual or Group) Personal or Consumer loans	Loans (also equity participation)	• Lease Financing • Business Loans • Mortgage Insurance Premium Finance • Factoring/Invoice Discounting	Loans to SACCOs
MSME portfolio outstanding (# of loans)	N/A	165 (cumulative)	420 accounts	Loans to SACCOs: 11
MSME portfolio size outstanding (value of loans)	MK 12.3 million (USD 95,536)	Either MK 148.8 million (USD 1,155,750)	MK 650 million (USD 5,048,639)	Loans to SACCOs: MK 72.2 million (USD 560,787)
NPL in MSME portfolio	PAR >30 days =6%	26%	7% (“infection ratio”)	PAR > 30 days = MK 13.9 million = 19% (USD 107,963)
MSME minimum loan size	MK 1,000 (USD 8)	MK 500,000 (USD 3,884)	MK 100,000 (USD 777)	Loan to SACCOs: MK 250,000 (USD 1,942)
MSME maximum loan size	Indiv. loan: 200% of savings Group loan: 500% of group savings	MK 2 million (USD 15,534)	MK 50 million (USD 388,357)	Loan to SACCOs: MK 32 million (USD 248,548)
MSME average loan size	MK 12,800 (USD 99)	N/A	MK 2.5 million (USD 19,418)	MK 500,000 (USD 3,884)
MSME loan term minimum	1 day	12 months	N/A	6 months
MSME loan term maximum	10 months	36 months	60 months	12 months
MSME loan interest rate	27% (+1% fee)	32% (+1.75-3% fees)	30-32% (+1% fee)	27%

B5. GOVERNMENT OF MALAWI

Five GOM organizations and programs providing credit were interviewed to get the most complete picture possible of the credit supply for MSMEs. While none of these organizations or programs can be DCA partner lenders or borrowers due to their ownership, information was collected to determine the extent to which lending under a potential guarantee might have competition from government sources, and to identify any synergies between a potential guarantee and any of the non-financial services aspects of these programs. Brief descriptions of each are presented below, and key data on the core credit products of each of the institutions are presented in Table 3-4.

Malawi Rural Finance Corporation (MRFC). MRFC supplies more than 50 percent of microcredit in Malawi and is highly dependent on subsidies, although it has been making recent strides toward operating on a more commercial basis.[5] MRFC offers seasonal agriculture loans, medium-term agricultural loans, small business loans, and personal loans to salaried employees. Because of its historic portfolio concentration in agriculture, particularly tobacco, MRFC has been overcoming poor repayments on tobacco and other loans that could not be repaid due to drought and/or lower tobacco crop prices. MRFC also participated in the small CNFA guarantee facility for 50 percent loan guarantees to facilitate inputs financing. It is possible that there could be some competition between MRFC seasonal input lending and lending under a potential DCA guarantee, depending on the guarantee objective and design, which could for instance focus on longer term loans.

Malawi Savings Bank Limited (MSB). MSB is the government owned successor to the failed Postal Savings Bank, and as of the 2004 Microfinance Assessment it was "in precarious financial condition." While MSB has significant outreach across Malawi with over 330 service points, the bank currently reports that it has only an 8 percent portfolio concentration in MSME loans worth MK 50 million (USD 388,357). MSB will consider MSME loans up to MK 5 million (USD 38,836) to businesses employing up to 100 people. Due to ongoing challenges affecting its financial strength, management focus, and the bank's low level of penetration into the MSME market to date, it is not expected that credit provided by MSB would compete with loans provided under potential DCA guarantees.

Malawi Rural Development Fund (MARDEF). MARDEF was established by the GOM during the last election cycle: it provides group loans to enterprises with a 15 percent flat interest rate and grace periods from six months and longer to fulfill a campaign promise. As of the date of this assessment, 2,837 group loans had been approved (although some still not disbursed) worth MK 393 million (USD 3,052,485) in different districts in Malawi. MARDEF will most likely not compete directly with a DCA guarantee facility, since there are many factors discouraging borrowers from taking loans from MARDEF (such as delays in approvals and disbursements making it difficult to finance agricultural inputs, and ceilings on portfolio value by constituency and district).

MARDEF could, however, negatively impact the DCA loan guarantee environment if its untested staff and systems for monitoring and collecting loans result in large numbers of defaults and client over-indebtedness, thereby promoting a poor loan repayment. Additionally, the sub-market interest rates offered by MARDEF could discourage potential

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[5] MF Assessment

clients from using an LPG facility that posts higher interest rates intended to cover its costs and help move it toward institutional sustainability.

DEMAT. The Development of Malawian Enterprises Trust (DEMAT) has five main programs: Business Advisory Services and Training, Technical Advisory Services and Training, Business Advisory Services for Women, Credit Services, and Special Programs.[6] DEMAT is funded by the GOM, donors, and revenue collected by charging a cost-recovery based fee to clients for business services. DEMAT was a partner in a UNDP/UNCDF credit project that ran from 1992 to 2003 where repayments were not strong (see Section B.2.3. below). It is still actively providing credit to MSEs through a new KW 8 million credit scheme being piloted in Thyolo, Salima, and Nkhata Bay, but it is not expected to compete at all with any lending under a DCA guarantee. It is possible that some of DEMAT's business services clients may be attractive to guaranteed lenders.

Small Enterprise Development Organisation of Malawi (SEDOM). SEDOM, another institution wholly owned by the GOM, has a number of credit facilities for MSMEs, including a Fisheries Development Fund Loan Facility, Microenterprise Loan Facility, Private Sector Development Fund (PSDF) Loan Facility, and Consumer Loan Facility provided at subsidized terms. The fisheries facility is funded by the African Development Bank. Since SEDOM's credit is very targeted by client type and location, it is unlikely that these facilities will compete with lending to MSMEs under any potential DCA guarantees.

[6] MF Sector Assessment, 2004

Table 3-4. Credit Supply by Government of Malawi Organizations

	MRFC	MSB	MARDEF	DEMATT	SEDOM
Outstanding portfolio (number of loans)	N/A	82	2,837	N/A	N/A
Size of outstanding portfolio (value of loans)	N/A	MK 50.7 million (USD 393,794)	MK 393 million (USD 3,052,485) (unclear if all disbursed)	N/A	N/A
NPL / Gross Loans or Portfolio at Risk > 30 days	N/A	7.4%	N/A	N/A	N/A
Credit Products Available	N/A	Leasing Working Capital Loans Project Finance Bridging Finance	Group loans	Group loans	Microenterprise Fund (MEF) Fisheries Dev. Fund (FDF) Private Sector Dev. Fund (PSDF) Consumer Loan Facility
Minimum loan size	MK 5,000 to individual (USD 39)	MK 10,000 (USD 78)	MK 10,000 (USD 78) per individual in group	MK 20,000 (USD 155) per individual in a group	MEF: MK 100,000 (USD 777) FDF: No minimum stated PSDF: MK 100,000 (USD 777) Consumer: N/A
Maximum loan size	MK 2 million to individual (USD 15,534)	MK 5 million (USD 38,836)	MK 100,000 per individual in group (USD 777)	MK 50,000 per individual in a group (USD 388)	MEF: MK 300,000 (USD 2,330) FDF: MK 100.000 (USD 777) for working capital, no max for term financing PSDF: MK 8 million (USD 62,137) Consumer: N/A – tied to salary
Average loan size	N/A	MK 619,000 (USD 4,808)	MK 138,526 (USD 1,076) based on outstanding portfolio figures	N/A	
Loan term minimum	Ag loans – seasonal Non-ag loans: 6, 12, 18, 24, 36 month maturities		N/A	6 months	All types: N/A
Loan term maximum	See above	36 months	12 months for ST business loans More for MT business loans	6 months	MEF: 12 months FDF: 12 months for WC, 36 months for Term Loans PSDF: 12 months Consumer: 12 months
Loan interest rate	33%, 32%, 30% on declining balance	32%	Fixed at 15%	48%	MEF: 25% FDF: 29% PSDF: 20%

B6. DONOR PROGRAMS

A number of international donors are active in supporting MSME finance in Malawi. DCA guarantees cannot be used with donor lines of credit, donor grants, or donor guarantees, so it is important to be aware of the types of credit programs that each of the major donors in Malawi is supporting. The following programs and/or facilities are worth noting to ensure the design of any DCA guarantees creates additionality without overlap.

USAID Community Partnerships for Sustainable Resource Management in Malawi (COMPASS II) Funds.[7] USAID's COMPASS project has made two capital grant awards to date under its program to facilitate the financing of natural resource based enterprises (NRBEs) at different points along the value chain. The recipients (financial institutions) will use the grants to provide loans to natural resource based enterprises with particular emphasis on production, processing, or trade in natural resource based products that is likely to result in substantial increases in incomes for rural households in Malawi. The financial institution recipients will develop loan products with competitive interest rates, identify qualified loan candidates, develop repayment terms, disburse and collect loans, and monitor the performance of the recipient's loan towards attainment of COMPASS program objectives.

Two capital grants have been made to Malawian financial institutions: the first, totaling USD 50,000, to NBS Bank for lending through the Community Development NRBE Loan Product/Window; and the second equal to USD 300,000 to National Bank for lending through the NRBE Investment Fund Loan Product/Window. Neither of the banks has made any loans to date, as they have just received the grants and are exploring the market. There is at least an additional USD 350,000 that has been programmed by the COMPASS project as grants to two more financial institutions, but it is unclear whether there is a sufficient NRBE credit demand at this point. Regardless of how NBS Bank, National Bank, and any future financial institution partners use the grants, they are not the institutions' own funds and cannot be guaranteed using DCA. Additionally, it is not recommended that any DCA guarantees focus on NRBEs unless they fall into a different category of agricultural lending and are being targeted by a financial institution willing to lend its own funds with a partial credit guarantee.

International Finance Corporation (IFC) MSME Finance Program. The IFC recently launched its MSME finance program for Africa to work with commercial banks in sub-Saharan African countries to help them move down market with the assistance of a credit line and an on-site advisor to be embedded within the bank for up to two years. IFC contractors have been active in approaching the commercial banks in Malawi about participating in the program; of the commercial banks interviewed, FMB, NBS Bank, and National Bank are in the final stages of consideration. It is likely that the target client market for the IFC program will end up being SMEs rather than microenterprises. Technical assistance will be provided to each participating lender for market assessment, credit product development, credit officer training, loan monitoring and collection, etc. which could enhance the chances of success of any potential DCA guarantees with those institutions. However, DCA could not guarantee loans made under the special concessionary credit line provided by the IFC for on-lending.

European Investment Bank (EIB). EIB — which has a mandate to develop the financial sector in the countries where it is active — has a strong interest in Malawi, and is currently

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[7] COMPASS RFA for grants for NRBE Loan Product/Window and NRBE Investment Fund Loan Product/Window.

looking to fill a gap in the credit markets for longer-term hard currency financing. EIB assistance will be offered as foreign exchange (forex) credit lines to a small subset of commercial banks which are not able to access hard currency funding. The size of projects EIB would support through the participating banks would be between € 200,000 and € 3 million, and not necessarily limited to agriculture. However EIB's August mission to Malawi focused on financing for ILOVO, a Malawian sugar company, that would allow ILOVO to upgrade and support a larger base of smallholders; EIB is also interested in the tea and coffee subsectors. As mentioned previously, DCA cannot guarantee financing provided by another donor or international development banks; however USAID/Malawi could re-establish communication with EIB if it decides to pursue any DCA guarantees since there could be directly complementary financing facilities established in sugar and tea.

NORSAD. NORSAD is a joint program among the Norwegian government, other Scandinavian countries, and the members of SADC. NORSAD, like EIB, has a variety of financing products including guarantees and credit lines. It has been less active in Malawi over the past few years due to the poor economic situation, but is now exploring the possibility of providing longer-term credit lines through some of the Malawian commercial banks to finance projects in the tea sector, a large fisheries project, and manufacturing projects. The NORSAD credit lines are not imminently expected, and no competition with lending under a DCA guarantee is foreseen.

African Development Bank (ADB). Through its Poverty Reduction Project, the ADB has been providing grants to SEDOM to subsidize loans to fisheries in certain districts (see earlier description of SEDOM). Additionally, ADB has provided over USD 1.8 million in soft credit lines to FINCA Malawi for rural microenterprise lending in the southern region, to MRFC for lending in the Central region, and to FITSE for lending in the northern region. The USD 1.8 million is intended to be a revolving credit line; however, due to its small size and different criteria for targeting the on-lent credit, it is not expected that lending under any potential DCA guarantees would compete with this program.

B7. CREDIT GUARANTEES

There has been some historic experience with loan guarantees and soft credit facilities in Malawi aimed at providing stimulus for targeted lending to both MSMEs and the agricultural sector, and a few guarantees are active according to the research conducted during this assessment. Should USAID/Malawi consider any of the options to use USAID's DCA guarantee products presented in Chapter Seven, it is important to be aware of existing guarantees and subsidized credit programs in the market so as to ensure that additionality is part of the guarantee design. Additionality in this context means that DCA would correct a credit market imperfection, and credit would not be provided to this segment of the market or sector without the guarantee.

The UNCDF implemented a USD 200,000 guarantee program to facilitate increased lending to MSMEs, which was implemented through Stanbic Bank and National Bank, with borrowers organized and trained by DEMAT. The program was not considered successful by most parties since there were high defaults and claims; the facility grew only a nominal 1.4 percent from interest reflows; and the roles were structured so that no party had an incentive to closely monitor borrowers. The remaining amount of the guarantee fund (approximately USD 100,000) has been transferred to DEMAT for their credit program.

The only existing relevant guarantee in Malawi identified during this assessment is one being implemented by the Citizens Network for Foreign Affairs (CNFA)/RUMARK to support inputs financing. The CNFA/RUMARK program has been operating a USD 50,000 revolving guarantee scheme to facilitate inputs financing. The guarantee agreement is established between CNFA/RUMARK and the inputs supplier to cover 50 percent of losses, should any of the shops receiving inputs on credit not repay. To date the firm has worked with 14 fertilizer, chemical, and seed suppliers to provide inputs on credit to 151 shops, guaranteeing 50 percent of approximately MK 30 million (USD 233,014). Of the MK 15 million (USD 116,507) that was covered, MK 580,000 (USD 4,505) has been filed as claims. CNFA/RUMARK is maintaining the actual guarantee fund in Washington, DC to avoid devaluations and maintain its value, and is considering using the remaining amount of the guarantee fund to cover cash loans from OIBM to agro-dealers. Since this guarantee fund is such a small amount and is very targeted at the input suppliers, no overlap is anticipated between it and any DCA guarantees.

C. CREDIT DEMAND

C1. MICRO AND SMALL ENTERPRISES (MSES)

The Malawi National GEMINI MSE Baseline Survey of 2000[8] sampled over 22,000 rural and urban households and small businesses with up to 50 employees. The 2004 Microfinance Sector Assessment[9] expanded the calculation for estimated credit demand from MSMEs to include households not selling 50 percent or more of their production. While the Baseline Survey counted 200,000 microenterprises and approximately 547,000 small enterprises, the Microfinance Assessment yields a much higher number of MSMEs, including up to 8.5 million people employed in agriculture that may have demand for microloans.

Per the MSE Baseline Survey figures, it was estimated that 747,000 MSEs exist in Malawi, which employ over 1.7 million people or 38 percent of the total labor force. Annual turnover at these MSEs was not large. Twenty-six percent had gross annual sales of less than MK 10,000 (USD 78) in the survey year (2000), 21.3 percent had sales between MK 10,000 – 20,000 (USD 78 – 155), and 23.7 percent had annual sales between MK 20,000 – 50,000 (USD 155 – 388). At the time of the survey the MK/US$ exchange rate was about 60:1 so MK 10,000 (USD 78) equaled about USD 166 and MK 50,000 (USD 388) equaled about USD 833. This level of turnover indicates that these enterprises could be considered potential clients for microcredit loans, which in 2003 when the Microfinance Sector Assessment was completed was defined as having an approximate value of USD 145.

As for the percentage of satisfied credit demand — the number of MSEs who were able to access microcredit – the Baseline Survey found that only 6 percent of MSEs surveyed received credit some time during the five years prior to the survey. From the data collected for the credit supply study, the total number of clients in the outstanding portfolios of the MFIs, the GOM credit programs, and the majority of OIBM's current clients (6,800) comes to a total of 48,120 clients,[10] still not the bulk of the MSEs in the country.

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[8] MSE Baseline Survey, 2000.
[9] MF Sector Assessment 2004.
[10] Note that in cases where it was apparent that MFIs were counting group loans, that figure was multiplied by the number of people per group to arrive at a figure for total number of clients.

Data from the recent credit supply and demand analyses conducted by DMS on the tea and coffee sub-sectors shows that there is still unmet demand by smallholders that may or may not have accessed credit previously for additional working capital; and medium term financing for new growers for which a term of over 36 months may be needed to repay credit; and financing for nurseries to house plant material.[11] Additionally, in the case of coffee there is significant unmet demand for credit by Savings and Credit Unions (SACUs) for inputs financing.[12] Considering the short-term working capital products being offered by financial institutions to this market, further research outside the scope of this assessment might explore how often MSEs are being reached with credit that has terms appropriately tailored to their business activity.

Anecdotal evidence from financial institutions, associations, and others indicates there is unmet demand for credit, particularly by smallholder farmers. For instance, ECLOF reported a waiting list for loans worth at least MK 8 million (USD 62,137), and both NABW and FITSE mentioned that there is a significant amount of demand that they are unable to meet due to a shortage of capital. The National Association of Smallholder Farmers of Malawi (NASFAM) stated that they could have disbursed an additional MK 472 million (USD 3,666,089) to purchase crops from farmers associations during the 2005/2006 cycle but they were unable to source financing.

C2. SMALL AND MEDIUM ENTERPRISES (SMES)

The GOM and Malawi donor community have paid much less attention to understanding and promoting the development of SMEs as opposed to MSEs. This is just beginning to change as the IFC and other donors are approaching the commercial banks to help them move down market into SME lending, and awareness is growing within the GOM about SME contributions to economic growth and indicators related to the health of the business climate.

However, it is still difficult to extrapolate a firm figure for the number of SMEs in Malawi since there have not been many studies of this market. The 2006 Investment Climate Assessment[13] indicates that access to credit becomes less of an obstacle for businesses as they increase in size, however formal sector firms (classified for this study as those registered with the GOM) “rank the cost of finance as a major problem more often than micro firms.” According to this study 67 percent of small firms and 81 percent of medium sized firms cited cost of finance as a major constraint. Additionally, the Investment Climate Assessment found that “SMEs are less than half as likely to use bank financing as larger firms.” This could be interpreted to mean that they are using other non-bank financial institutions such as leasing companies or discount houses, since commercial banks are more likely to serve the higher end of the SME market. Alternatively, the study’s findings could indicate that a substantial portion of SMEs are not having their credit needs met.

Part of the information collection effort for this assessment included a questionnaire to quantify the number of rejected loan applications by financial institutions in the first six months of 2006 as a proxy for unmet credit demand. The commercial banks reported rejecting a significant number of SME loan applicants during the first half of the year. NBS Bank alone rejected 64 potential clients requesting loans worth MK 264 million (USD

[11] Tea sector study, Kadale Consultants, 2006.
[12] Coffee sector study, Kadale Consultants, 2006.
[13] 2006 Investment Climate Assessment, Rped, Africa Private Sector Group.

2,050,524), and National Bank reported rejecting 99 potential clients with loan requests for more than MK 234 million (USD 1,817,510), which does indicate a significant amount of unmet credit demand. Using these two banks as representative, the top two reasons for rejecting clients were lack of credit history, and a lack of sufficient collateral. These issues and other credit market imperfections are discussed in more detail in Chapter Five.

CHAPTER FOUR: CONSTRAINTS AND CREDIT MARKET IMPERFECTIONS IN MALAWI

A. ACCESS TO CREDIT INDICATORS

This section of the report reviews Malawi's scores on standardized benchmarking indicators for enabling environment factors contributing to access to credit. Additionally, this section identifies specific credit market imperfections impacting the flow of credit applying to all MSMEs, with segmentations within that group including microenterprises, SMEs, and agricultural MSMEs.

The World Bank's annual *Doing Business* report is one of the means by which countries can be benchmarked in different areas contributing to the overall business climate in an economy. *Doing Business* includes "Getting Credit" as one of the 10 groups of indicators used in their measurements. These indicators focus on enabling environment factors affecting ease of obtaining credit by borrowers categorized into features of a credit information system and coverage by public registries and private credit bureaus. As demonstrated by the summary data in Figure 4-1 below, Malawi's legal framework is conducive to promoting access to credit. However, Malawi received the lowest possible scores for credit information, which is a significant barrier to the expansion of credit to MSMEs.

Figure 4-1: Malawi Getting Credit Summary

Getting Credit (2006)[14]

Measures on credit information sharing and the legal rights of borrowers and lenders in Malawi are shown below. The Legal Rights Index ranges from 0-10, with higher scores indicating that those laws are better designed to expand access to credit. The Credit Information Index measures the scope, access and quality of credit information available through public registries or private bureaus. It ranges from 0-6, with higher values indicating that more credit information is available from a public registry or private bureau.

Indicator	Malawi	Region	OECD
Legal Rights Index	8	4.2	6.3
Credit Information Index	0	1.3	5.0
Public registry coverage (% adults)	0.0	1.5	8.4
Private bureau coverage (% adults)	0.0	3.8	60.8

Details | Compare All Economies

B. GENERAL OBSERVATIONS ON CREDIT MARKET IMPERFECTIONS

No credit reference information or national identification systems. Many countries in sub-Saharan Africa do not have a comprehensive credit reference information system; Malawi does not even have a personal identification system. The lack of a national ID presents a large risk factor for financial institutions which are unable to judge the amount of outstanding debt a potential credit client has, or the client's repayment history with other

[14] World Bank Doing Business Report, September 2007 showing 2006 data.

institutions. Additionally, it appears relatively common for micro and small entrepreneurs (seemingly less so for medium sized entrepreneurs) to receive multiple loans from one institution by simply changing the order of their first and middle names since there is no way to reference it back to an ID number. This significant risk factor causes lenders to be extremely cautious in extending credit, and to increase the interest rate charged to somewhat offset this risk when they do extend credit.

General information asymmetry. Recent activities undertaken by the DMS project, including the Rural and Agricultural Finance training and sector studies on tea and coffee, indicate a general lack of communication between the financial sector and other private sector entities and the general public. This lack of information inhibits lenders' interest in exploring potentially profitable opportunities in less familiar sectors, and in understanding credit risk for particular sectors.

Confusion about grants versus loans. In the recent past, the GOM has undertaken a number of social development programs, some with an underlying political motivation, which included a credit component that did not operate according to international best practices. The mixed messages received by the public about its obligation to repay loans under these programs, as well as (indirectly) commercial loans, combined in many cases with weak loan monitoring and collections, has created what Malawian lenders refer to as a culture of non-repayment. This increases lenders' perceived risk about potential defaults, either due to borrower unwillingness to pay or due to GOM existing or future distortion of markets.

High collateral requirements. For both microenterprises and SMEs, lender collateral requirements are difficult to meet. While microfinance lenders are somewhat more flexible on the type of collateral accepted, microenterprises often have difficulty even as a group in coming up with the cash collateral required to borrow. Most Malawian commercial banks typically require cash, real estate, or vehicles for up to 150 percent of loan value. Most SACCOs offer loans only against deposit balances, but at a relatively conservative ratio, such as loans offered at 80-90 percent of deposit balance.

High real interest rates. Due to GOM domestic debt, the inflation rate and devaluation of the Malawian Kwacha, real interest rates (per Chapter Five) are well above 30 percent per annum on local currency loans. High rates are believed to have stifled demand for credit in the past, because businesses chose to self-finance rather than pay such a high rate for credit.

Limited term financing. The financial institutions interviewed report a very limited volume of medium and long term financing in Malawi. According to the commercial banks, this is due to concerns about the longer term stability of the economy and their short term deposit structure. For instance, OIBM offers one of its term credit products intended for fixed asset purchases for a term of 18 months even though they know that most businesses would require 24 months or more to pay off the larger loan amount because the bank is concerned about increased macroeconomic risk. Most of the micro credit providers interviewed seemed to be focused on improving the performance of their portfolios of working capital loans for the time being, and that may be due in part to lack of term loan capital. MUSCCO stated that "insufficient loanable funds makes it difficult to lend on long term basis, and the high cost of borrowing is a hindrance to lend for purposes of acquiring fixed assets and other forms of infrastructure development."

Currency matching issues. While this applies primarily to medium enterprises and larger projects that wish to borrow in USD or South African Rand (ZAR) primarily for medium and longer term upgrades and investments, foreign exchange is a constraint for those commercial banks in Malawi that are not affiliated with a South African parent. Most Malawian banks are unable to access foreign exchange credit lines at reasonable rates and are limited by the RBM as to how much foreign currency they can lend. Meetings during this consultancy indicate that a number of donors are working on this issue, including the European Investment Bank, NORSAD, the Netherlands Development Finance Company (FMO), and the International Finance Corporation, as presented in Chapter Five.

Excess liquidity. Interviews indicate it is probable that Malawian commercial banks are maintaining liquidity in excess of RBM requirements, which effectively reduces the amount they are able to lend. (DMS follow up with the RBM should clarify and confirm their specific requirements.) The excess of RBM requirements may be because T-bill rates have significantly reduced and are not attractive for banks anymore. At the same time, even though banks have begun to diversify loan products, especially consumer lending, they are still slow in dealing with the low income earning bracket. Considering the estimated level of unmet demand for credit, this clarification could be an important first step in helping the commercial banks to increase lending to SMEs.

C. MICROFINANCE CREDIT MARKET IMPERFECTIONS

There are a few specific credit market imperfections constraining microfinance in Malawi. Those presented below refer only to private microfinance providers, and do not include any GOM lending programs.

Limited loan capital for on-lending. Within the current legal framework, microfinance companies and NGO credit providers are not allowed to intermediate deposits. Additionally, while some microfinance companies have been able to attract loans from local commercial banks, it was with 100 percent guarantee coverage from either a donor or a parent institution, rather than secured by the MFI's portfolio, which banks will currently not consider as security. If they were able to borrow without a full guarantee, the MFIs assume they would be paying significantly above the market rate for their funds. Therefore, microfinance lenders have limited sources of capital from which to lend, and this is a limitation on their ability to expand their outreach.

Limited credit products. Credit products offered by MFIs, NGO microlenders, and SACCOs are for the most part short term up to 12 months, and are primarily designed for working capital needs and consumer finance purposes. Additionally, in the case of the MFIs many of the product series' have fixed tranches, i.e. Loan 1 = MK 5,000 (USD 39), Loan 2 = MK 10,000 (USD 78), etc. even if the borrower (or group) could absorb more credit. However this situation is beginning to change as a number of MFIs, including FINCA and PRIDE, have recently introduced individual loan products to the market.

Insufficient geographic coverage. Despite having a commercial bank focused on microfinance, and a number of donor supported micro credit programs and institutions, rural markets have still not been penetrated, and outreach outside the major urban, peri-urban, and boma (District Administrative center) areas is still limited. Most financial institutions cited the high cost of establishing infrastructure as the key constraint to expanding geographically. Additionally, the MFIs cited lack of capital for expanding lending. For the commercial banks and some of the NBFIs, interview and survey responses indicated that they did not believe there was sufficient concentrated demand outside of major urban and peri-urban areas to justify their costs in establishing a presence there.

D. SME CREDIT MARKET IMPERFECTIONS

These credit market imperfections are focused on SMEs and commercial banks, which are their most likely source of credit due to their level of formalization and the size of credit they would typically require.

Limited SME business capacity. Aside from having limited traditional collateral to pledge as already described, the majority of SMEs in Malawi do not have sufficient business skills to produce business plans or financial statements of the sophistication required by commercial banks.

Limited bank knowledge and capacity. Reliance on T-bill returns has left limited incentive to build capacity to properly analyze SME borrowers, that is, evaluate, mitigate, and appropriately price risk. While many of the commercial banks interviewed indicated interest in moving into SME lending, none have collected any market information and/or piloted new products to this market.

Limited diversity of credit products. As described above for microfinance, there is not much diversity in terms, types of acceptable collateral, or interest rates currently being offered by commercial banks to SMEs they are willing to finance. Additionally, larger or more mature SMEs may want to borrow in hard currency for longer term capital upgrades and expansion, which their banks are reluctant to offer since they do not have access to large amounts of forex.

E. AGRICULTURE FINANCE CREDIT MARKET IMPERFECTIONS

Since more than 85 to 90 percent, depending on different estimates, of Malawi's economy is based on agriculture, a significant number of the microenterprises and SMEs that might benefit from a USAID/Malawi DCA guarantee are linked to agriculture. Some specific credit market imperfections which affect financing of the agriculture sector in Malawi are presented below, excluding any related to microenterprise or SME finance more broadly which have already been discussed.

GOM agricultural policies. The GOM has historically been very involved in the agriculture sector, and recently has promoted policies that have created concern among lenders, producers, and other private sector entities related to agricultural input subsidy programs and price ceilings on tobacco, the country's principal cash crop. As mentioned above under general credit market imperfections, GOM has also launched a number of rural and MSME credit programs that are not in all cases operating with best practices and are distorting the credit market for this sector.

Limited use of contracts. The use of commercial contracts for farming is not widely practiced in Malawian agriculture, with the exception of tobacco and some seed maize farming, and some outgrower credit schemes for crops such as coffee and tea[15] that provide smallholders access to credit if they sell their production to a larger estate or processor. It is not common to obtain warehouse receipts, which could serve as a proxy for a stored quantity and quality of a particular crop and be used as security against which a producer or cooperative could borrow. It is expected that these types of instruments will develop as

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[15] Credit Demand and Supply in the Tea Sector, Kadale Consultants, July 2006.

progress is made in developing the commercial warehousing infrastructure and collateral management system.

Nascent insurance market. The market for agricultural insurance to hedge against weather, price, disease, and other risks is nascent in Malawi. Lenders that are not able to offset a portion of the risks inherent in agriculture are reluctant to extend too much credit to a sector already impacted by extreme seasonality.

Lack of diversification. Malawi has been dependent on tobacco as a key cash crop for a number of years, as well as a limited number of other crops such as tea and maize. Lenders have learned how to extend credit to these subsectors, but their risk remains concentrated in a few crops, including one facing GOM price ceilings. Lenders are not familiar with newer substitution crops (such as cassava), and are hesitant to lend to businesses and smallholders growing them.

High cost of meeting rural demand. Due to the small size of each smallholder farm and the way production must flow from that system, it can be difficult and expensive for lenders to extend credit in very rural areas. Even when credit demand has been organized into cooperatives it can still be costly for lenders to enter this market, thereby limiting the amount of commercial credit to the agricultural sector.

CHAPTER FIVE: GUARANTEE DESIGN AND DEVELOPMENT

A. DCA DESIGN CONSIDERATIONS FOR MALAWI

As described in Chapter One, USAID/Malawi has been implementing its Sustainable Economic Growth portfolio of programs with a decreasing budget over the past two years, and a number of its projects are reaching completion in 2006. The mission will explore how DCA guarantees might complement new programs being planned under its new Country Operating Plan (COP). Regardless of the strategic framework the mission is operating under, the amount required for DCA subsidy cost, the amount the mission must pay for DCA guarantees will be a significant consideration in implementing any partial guarantee facilities. The mission has limited human resources to dedicate to the implementation of any guarantee facilities; this should be taken into consideration at the design and development phase.

This section of the report focuses on critical aspects of DCA guarantee design and development, including how the mission's cost is calculated; strategies for reducing the mission's cost; different implementation models; and the process and phasing by which USAID/Malawi can move forward should it choose to establish a DCA guarantee facility.

A1. RISK AND COST TO USAID/MALAWI

For each DCA activity, a loan loss reserve similar to an insurance premium is moved from the USAID Operating Unit to the U.S. Treasury in advance to cover claims paid out to lenders on defaulted loans under DCA guarantee coverage. This is known within USAID as the "subsidy cost" for a guarantee, and it is paid by the mission, bureau, or office which is the originator and/or sponsor of the activity.

Weighted Average Risk Factor (WARF). Many variables affect the subsidy cost calculation which is based on the Weighted Average Risk Factors (WARF) score calculated by the USAID/Office of Development Credit. Four factors contribute to this score, including: country risk, lender risk, borrower risk, and transaction risk. The country risk rating is always weighted at 40 percent of the calculation and is determined by the ICRAS (Inter-Agency Country Risk Assessment System), and the mission has no control over this factor. In Malawi's case, the country risk score is a "9" out of "10," primarily based on macroeconomic indicators driven by the 40 percent weighted country risk. It is possible but not likely that this rating could improve during the next round of ICRAS ratings if the economy moves in a positive direction. The lender and borrower risk vary according to the specific DCA product being used and range from 15-25 percent of the weighting each, and the transaction risk comprises the remaining portion of the risk score.

Table 5-1 presents illustrative calculations for the subsidy cost that could potentially be borne by the Mission for one to three DCA loan portfolio guarantee(s) in Malawi. These notional figures are based on percentages derived from another country with a "9" out of "10" country risk rating, and are based on a Loan Portfolio Guarantee structure, although in Section VII Loan Guarantees and Portable Guarantees were also proposed according to the Mission's core objectives. *Notional and final subsidy costs for any DCA guarantee activities undertaken by the mission would be calculated by the USAID Office of Development Credit as part of the risk assessment process (see Chapter Five).*

Table 5-1: Illustrative Subsidy Cost Figures for DCA Loan Portfolio Guarantees in Malawi (based on country rating of "9" out of 10)

Total Facility Value of LPG	Guaranteed Portion at 50%	Term of Guarantee Facility	Estimated Subsidy Percentage	Preliminary Estimate of Subsidy Cost	USAID Budget Leverage per $
One Bank					
$5 million	$2.5 million	3 years	5.41%	$270,500	18.48
$5 million	$2.5 million	5 years	7.39%	$369,500	13.53
Two Banks					
$10 million	$5 million	3 years	5.41%	$541,000	18.48
$10 million	$5 million	5 years	7.39%	$739,000	13.53
Three Banks					
$15 million	$7.5 million	3 years	5.41%	$811,500	18.48
$15 million	$7.5 million	5 years	7.39%	$1,108,500	13.53

Since the subsidy cost can be paid by USAID operating units, if USAID/Malawi did not have sufficient budget to cover the subsidy cost, it may be possible for the mission to request that the subsidy cost for a DCA guarantee facility be paid by either Africa Bureau and/or EGAT Bureau in Washington, DC, or that the mission could cost share this amount with one of the Bureaus.

A2. ADDRESSING MALAWI'S COUNTRY RISK SCORE

Missions have overcome high country risk ratings to structure DCA guarantees with affordable subsidy costs that still achieve the budget and results leverage intended. USAID missions in countries with risk ratings of 8 or 9 out of 10 that successfully established DCA guarantees during FY 2004 and FY 2005 include: Ecuador, Ethiopia, Georgia, Haiti, Rwanda, West Bank/Gaza, Zambia. Some of the design strategies to reduce subsidy cost for guarantees in countries with higher risk ratings include:

Select strong lenders for LPGs. Lenders with stronger ratings or CAMELS scores represent lower risk and will reduce the Lender portion of the WARF which translates into a reduced subsidy cost for the Mission.

Submit thorough LPG borrower cohort reports. The more concrete information and analysis the risk assessment team has on factors affecting the creditworthiness of a potential borrower group under an LPG the better. Less information can be construed as higher risk which impacts the Borrower portion of the WARF score and subsidy cost.

Select strong borrowers for loan and portable guarantees. Since the emphasis and heavier WARF weighting is on the borrower score for LGs and PGs, stronger borrowers, whether projects, enterprises, or smaller financial institutions, will generate better risk scores and therefore reduce subsidy cost.

Reduce percentage coverage. While the maximum risk sharing percentage under a USAID DCA guarantee is up to 50 percent, it is certainly possible to offer a partner less coverage which will reduce the subsidy cost paid by the mission. For instance, a USAID/Zambia LPG covered only 40 percent of net principal losses on a multi-bank warehouse receipts lending activity, and USAID/Rwanda covered only 40 percent of a commercial bank's potential principal losses for agribusiness lending under its LPG. One of the more recent DCA guarantees established in India for small and medium sized enterprise lending featured a variable coverage model, whereby the lender is able to lower its 50 percent coverage to a lower percentage for those loans that they feel are more risky than they would assume normally, but not quite as risky as those they would like to place under 50 percent coverage. This variable coverage model may somewhat reduce Mission subsidy cost, but USAID/ODC would need to confirm.

Limit the size and duration of the overall guarantee facility. The duration of a guarantee facility affects the subsidy cost a mission pays, with longer duration guarantees being higher risk and therefore higher cost. Additionally, since the subsidy percentage is applied on the total guarantee facility size, a smaller size facility will have a lower subsidy cost.

Define parameters for LPG sub-loan maturities and size. Longer maturity sub-loans under an LPG are also considered higher risk which would impact the mission's subsidy cost. However, the intent of the guarantee needs to be taken into consideration. For instance, if the principal credit market imperfection the guarantee is intended to address is that lenders are not offering term loans of more than 24 months maturity, then sub-loans should be 24 months or more, and other characteristics of the guarantee design can be modified to capture subsidy cost savings from another area. The maximum size of sub-loans can increase the subsidy cost since higher value maximum sub-loans concentrate risk in fewer borrowers.

Negotiate fees to reduce mission subsidy cost. The guaranteed party under a DCA guarantee pays fees to have the benefit of the coverage. A *commitment fee* is paid at the time of the signing of the guarantee Legal Agreement, and a *utilization fee* is paid semiannually against the guaranteed portion of total outstanding loan balances. The total amount projected to be paid in lender fees is netted out of the subsidy cost calculation as it offsets the total amount a mission must pay. Therefore increasing the commitment and/or utilization fees is another strategy missions can use to reduce their subsidy cost. USAID/ODC maintains a table outlining the parameters within which USAID missions in countries with a "9" risk score like Malawi may negotiate with partner lenders under LPGs, pairing lower commitment fees with higher utilization fees to ensure the net amount correctly offsets the U.S. government's projected risk.

A3. RESERVE BANK OF MALAWI TREATMENT OF GUARANTEE

While it pertains specifically to potential DCA guarantees with commercial banks, the Reserve Bank of Malawi's treatment of DCA guarantees could be an attractive feature for potential partner lenders. USAID has offered partial credit guarantees to facilitate lending to creditworthy enterprises and projects in numerous countries, often with commercial banks as lending partners. USAID partial credit guarantees are backed by the full faith and credit of the U.S. government. Guarantees can cover up to 50 percent of the guaranteed party's net losses of principal on qualifying loans.

In many countries, the Central Bank will allow the portion (up to 50 percent) of a loan or group of loans with a U.S. government guarantee provided through USAID to be risk-weighted at a lower amount than the standard risk weighting would be for that credit without an enhancement. This positively impacts the bank's capital adequacy ratio, in that they are required to maintain less capital due to the reduced risk weighting, and effectively can extend more capital as credit to additional borrowers.

The RBM has informed the DMS project that it would be able to modify the risk-weighting of loans that were partially guaranteed with a USAID DCA guarantee: "Fifty percent of the loan that is so guaranteed will be risk weighted at 20 percent. We understand the guarantee will be partial. The other portion will attract the risk weight of the counter party or the facility as the case may be (which in most cases is likely to be higher)".

A4. COMPLEMENTARY PROGRAMS

The most successful DCA guarantees reinforce capacity building, technical assistance, and policy reform efforts working toward the same goal. For this evaluation, information was collected from a number of donor and government programs that may provide synergies with any potential guarantees established by USAID/Malawi beginning in FY 2007. Table 5-2 presents those expected to provide the most direct complement to potential DCA guarantees.

It should also be noted that there may be synergies between a DCA guarantee facility and private sector entities in addition to donor and government programs. For instance the Malawi Confederation of Chambers of Commerce and Industry (MCCCI) is developing a course on strategic and business planning for its membership comprising a significant number of small and medium sized businesses. Larger agricultural enterprises and agro-processing firms may also serve as a complementary partner for potential DCA guarantees as contract farming and warehouse receipts financing develops and expands.

Table 5-2: Complementary Programs

Donor / Sponsor	Project Name	Description	Duration
USAID	DMS	Micro, meso, and macro level support for development of the microfinance sector.	2004 – 9/30/07
USAID	COMPASS	Increasing sales of natural resource based products by rural households	2004 - 2009
USAID	I-LIFE Consortium	Improving agricultural productivity in rural Malawi	2005-2009
USAID	NASFAM	Agricultural marketing and smallholder productivity enhancement	2003 - 10/31/06
USAID	Watershed Management	Sustainable agricultural practices to support increased crop production and diversification	2004- 9/30/07
IFC	MSME Finance Program	Credit line + embedded advisor to assist commercial banks in expanding MSME credit	Estimated 2007 - 2009
FAO	Cassava / Dairy	Supporting smallholder cassava and dairy, and working on proposal for dairy breeding farm with private sector.	Estimated 2007 - 2009
World Bank / MoA FJSTF	Agricultural Policy Reform and Agricultural Sector Investment Program	Supporting development of warehouse institutional infrastructure	Estimated 2006 - 2008
World Bank		MF strategy framework, overall financial sector strengthening	Estimated 2006- 2009
AFDB	Poverty Reduction Project	Supporting development of small fisheries (*also funding non-commercial microcredit program)	Ends December 2006
UNDP/UNCDF	Business Support program		Unknown
EIB	Support for longer term investment	Possible forex credit lines to banks for ag sector lending	Estimated 2007/2008
NORSAD	Support for longer term investment	Possible forex credit lines to banks for ag sector lending	Unknown

Donor / Sponsor	Project Name	Description	Duration
GOM	DEMAT	Business Services Program for MSMEs	Unknown

B. DESIGN AND DEVELOPMENT PROCESS

Based on discussions with USAID/Malawi, the preliminary allocation of roles and responsibilities in connection with DCA facility design and development is presented in Table 5-3 below. More specific information, along with the critical path and basic steps for designing and developing a DCA guarantee, are presented in Table 5-4.

Table 5-3: Proposed Guarantee Design and Development Responsibilities

DMS Project	USAID/Malawi
Prepare draft concept paper(s)	Submit concept paper(s) to ODC Representative
Work with partners and Mission to design guarantee details	Budget for estimated subsidy cost
Prepare draft action package(s) and supporting documents	Negotiate fees with partner lenders/borrowers
Prepare LPG Borrower Cohort Report(s) (BCR)	Coordinate with ODC to schedule risk assessment
Collect information from partners for Risk Assessment	Coordinate with RLA on legal agreement
Support Mission on Credit Review Board (CRB) presentation as required	Present to Credit Review Board (CRB)
Prepare for guarantee implementation as determined by USAID/Malawi	Transfer subsidy cost

Table 5-4 also shows a notional timeline for the design and development of any type of the three guarantees explored for this evaluation (loan portfolio guarantee, loan guarantee, and portable guarantee). This table provides a starting point for discussion and would be refined according to the guarantees USAID/Malawi would like to move forward in establishing. For any areas in which DMS project assistance may be required, preliminary estimates are provided in the table for the level of effort anticipated, in excess of the regular DMS project team, for each type of guarantee. The illustrative timeframe assumes that USAID/Malawi will be engaged with USAID/Washington sector assessments and completing its Country Operating Plan during the months of September and October, such that the earliest the mission would know about its available budget for any DCA guarantees would be November 2006.

Table 5-4: Process and Notional Timeline for Design and Development of DCA Guarantee(s) for Malawi

Action / Step in Process	Principal Responsibility	Estimated Project LOE (in excess of reg. DMS)	Illustrative Timeframe
Establish commitment of lenders (LPG) and/or borrowers (LG/PG) • LPG: Conduct initial discussions with lenders to discuss objectives and discuss potential portfolio size • LG/PG: Conduct initial discussions with potential borrowers and refine estimates of guarantee needs • Solicit letters of interest from short-listed partners	LPG: DMS LG/PG: DMS + USAID/Malawi		November 2006
Prepare and submit DCA concept paper(s) • Concept papers include preliminary design ideas, potential partners, possible size of guarantee facility, intended guarantee product • Respond to feedback from ODC • Request preliminary subsidy estimate from ODC	DMS + USAID/Malawi	Draft concept paper(s) included in this consultancy SOW LPG: Up to 2 days additional LOE LG/PG: Up to 2 days additional LOE	December 2006
Prepare and Submit to ODC: • DCA Action Package • Monitoring Plan • Financial Institution Information • Borrower Information (if LPG Borrower Cohort Report)	DMS + USAID/Malawi	Per Action Package: 12-15 days LPG BCR: 8-10 days per report LG/PG Borrower Report: up to 15 days depending on complexity and info. available	January 2007
Negotiate fees and terms with lenders (simultaneously with preparation of Action Package, etc.)	USAID/Malawi with assistance from DMS		January 2007
Prepare in advance for Subsidy Cost transfer • Request approval from State Department (if ESF) • Prepare and submit Congressional Notification (if subsidy not included in CBJ)	USAID/Malawi		February 2007
Conduct Risk Assessment and Financial Viability Analysis	USAID/ODC		February 2007
Present Guarantee to USAID Credit Review Board	USAID/Malawi with assistance from DMS and Chemonics HQ		April 2007
Transfer Subsidy Cost	USAID/Malawi		April 2007
Finalize Legal Agreement	USAID/Malawi and RLA		May 2007

C. IMPLEMENTATION MODELS

One of the key elements of designing a DCA guarantee is planning for its implementation. USAID Missions can choose from a number of models in which the mission is more or less directly involved in the ongoing implementation of the guarantee, according to its needs and preferences.

Implementation always includes a series of monitoring and reporting functions, and in addition, many guarantees also require a more technical component to increase use of a loan portfolio guarantee, or capacity building of a borrower for a loan/portable guarantee. At a minimum, USAID missions typically delegate the technical functions to an appropriate implementing partner – for instance, a technical assistance activity will continue at least through the first year or two of the guarantee duration. Technical functions in this sense could include, in the case of an LPG: lender relationship management; identifying training needs of lenders and identifying resources for conducting that training; and encouraging the lender to conduct a market assessment to help them extend credit to new types of borrowers that would be covered under their guarantee. In the case of an LG or PG, technical functions may be to build borrower capacity in general business skills or specialized skills.

Many missions also prefer that an implementing partner assume the majority of the monitoring and reporting responsibilities. These functions include monitoring the level of portfolio use, the quality of a portfolio or single loan, ensuring loans are made to qualifying borrowers, and assisting lenders in processing claims. DCA also requires annual site visits and a moderate level of reporting which can be prepared for missions by implementing partners. In this model, should a technical assistance activity be scheduled to expire, a transition plan to another entity would be developed during the first years of the guarantee. Based on Chemonics' experience implementing numerous USAID DCA guarantee facilities, it is safe to estimate that the monitoring, reporting, and basic technical responsibilities could be handled by a local professional for approximately four days/month per LPG after the initial two months of lending. The number of required days for monitoring and reporting might be slightly less for an LG/PG, although it is possible the capacity building needs could require a higher level of effort.

It is also possible for the Mission to hire a local firm directly to implement the guarantee, particularly focused on the monitoring and reporting functions. This model has been used by missions planning an exit strategy from the country. Monitoring and reporting by another mission in the region is also possibility.

During this consultancy, USAID/Malawi indicated an initial preference for having one of its implementing partners assume the majority of implementation responsibilities, and this plan would be refined during the design and development process. Whichever model USAID/Malawi selects, it will be presented in the DCA Monitoring Plan submitted to the USAID Credit Review Board along with the Action Package.

CHAPTER SIX: DCA APPLICATIONS FOR MALAWI

This chapter summarizes key findings with regard to demand for and potential applications of DCA guarantees that would help correct some of the specific MSME credit market imperfections described in Chapter V. Qualitative data on each of the private sector lenders who were examined for this evaluation are presented in Table 6-1 below. Possible medium term activities for a DCA loan guarantee facility in Malawi are presented in Tables 6-2 and 6-3; longer term possibilities are described on page 50. These activities should be reviewed in the context of the next Country Operating Plan developed by USAID/Malawi.

Models to use in customizing any DCA guarantee facility in Malawi derive from DCA's successful and wide use by USAID missions in sub-Saharan Africa and globally to stimulate private sector financing for MSMEs and for the agricultural sector. For reference, a representative sample of existing DCA guarantees from within and outside the region are presented in Annex F.

A draft DCA concept paper was prepared as an example for USAID/Malawi's consideration, which is appended to this report as Annex G. This concept paper proposes a multi-lender DCA loan portfolio guarantee facility to stimulate lending to MSMEs in the agriculture sector.

A. POTENTIAL PARTNER LENDERS

Seven private sector commercial banks, five MFIs, and four additional private sector NBFIs were evaluated for their potential to become partner lenders.

Table 6-1 below summarizes key information collected from the lenders, focused on their current appetite for lending to Malawian MSMEs, constraints or concerns the lenders expressed related to lending to this borrower cohort, and areas where technical or financial assistance could increase the lender's ability to extend credit to this group. Table 6-1 also includes recommendations as to whether each might be a suitable partner lender and whether they should be considered as a potential DCA partner lender.

Table 6-1: Potential Partner Lenders Assessment

Commercial Banks	Existing Portfolio Concentration in MSME	Urban vs. Rural MSME clients	Interest in MSME Sectors	Constraints to MSME Lending	Needed assistance to increase MSME lending	Potential DCA Partner Lender
First Merchant Bank	1%	80% Urban	Mining, agriculture, retail, education, transport	Borrower lack of good security, accounts, and credibility of clients	Will receive technical assistance from IFC MSME lending program	Yes
Indebank	N/A although majority to SMEs	Not targeting rural areas	Wholesale financing of MFIs Wide sectoral coverage – manufacturing, ag, construction, etc.	Identifying serious SMEs Lack of credit reference info. Previous experience with NPLs	Not specific aside from interest in guarantee products	Yes
Loita	N/A	Urban only	Tourism development	Focused on trade finance for larger companies	N/A	No
National Bank	N/A	N/A	NRBEs – has grant for onlending from COMPASS II	Bad experience with UNCDF guarantee program Weak business skills (hence establishment of BDS arm)	N/A	Possibly – indicated interest in guarantee if economy picks up
NBS Bank	Says none – operating as a retail/ consumer bank	N/A	Agriculture – tea, coffee, cotton Wholesale financing of MFIs	Lack of collateral, weak cashflows to support loan repayments, no past credit history	Will receive technical assistance and credit line from IFC MSME Finance program	Yes – has already submitted an expression of interest to DMS Project.
Nedbank	2.52%	85% Urban 15% Rural	Bank has different target market	Lack of security and financial information	N/A	Possibly for LG/PG – see Section VII B.
OIBM	Majority	65% Urban 43% Rural	Agriculture Tourism Businesses in further rural areas	Lack of collateral, lack of financial records, lack of transport to rural areas, delays in processing title deed documents	Skills in financial analysis	Yes – interested

Table 6-1: Potential Partner Lenders Assessment (Cont.)

MFIs	Existing Portfolio Concentration in MSME	Urban vs. Rural MSME clients	Interest in MSME Sectors	Constraints to MSME Lending	Needed assistance to increase MSME lending	Potential DCA Partner Lender
ECLOF	All except portion that are institutional loans	65% Urban 35% Rural	Would like to expand pro-poor approach into more rural areas – targeting 75% of portfolio to be rural by 2009 – and would like to expand in youth lending. Next year would like to lend to Credit Service Institutions, particularly in the Central and North regions to help expand coverage.	Limited loan funds (a. Unable to access extra funds from commercial, for instance due to due to I) lack of security ii) no wholesale funds. b. Large doubtful/uncollected debts. Inadequate IT / MIS to process loan applications. Skills gaps in staff.	Credit guarantee to cover loans extended to clients and loans obtained by ECLOF Malawi. Accessing appropriate levels of loan funds. Appropriate office equipment. Staff capacity building	No
FINCA	100%	N/A	Agriculture – irrigation equipment	Cannot intermediate savings	Focused on retaining staff and portfolio quality right now	No
FITSE	100%	Urban: 42% (urban and periurban) Rural: 58%	New Outlets in the Southern Region New Products to existing & new markets	Loan capital Cash Flows do not support repayment Lack of Collateral	Loan capital	Possibly after FSS improves and World Vision equity placement
NABW	100%	Urban: 30% Rural: 70%	Expanding to lakeshore districts and to border regions to help finance cross-border trade. Would like to help clients graduate to next level.	Loan capital Group does not have viable project Location or timing of marketing not viable	Loan capital + technical assistance	No
Pride Malawi	100%	75% Urban 25% Rural	Fisheries Industry, Cotton Industry and Tea and Coffee Industry	Loan capital Risky start ups Insufficient collateral	Yes	Not at this time

Table 6-1: Potential Partner Lenders Assessment (Cont.)

Non-Bank Financial Institutions	Existing Portfolio Concentration in MSME	Urban vs. Rural MSME clients	Interest in MSME Sectors	Constraints to MSME Lending	Needed assistance to increase MSME lending	Potential DCA Partner Lender
Fincoop	N/A	50% Urban 50% Rural	Agriculture Agro-processing Small scale manufacturing	Loan capital Default Inadequate collateral by most potential borrowers - Mobility Challenge in some potential outreach areas -Requested loan size beyond the requirement	- line of credit, - capacity building for credit officers - credit guaranteeing to minimize risk - Transport to reach out to many people in rural areas through mobile branch services	**No**
Indefund	N/A	N/A	Agriculture, tourism, transport, mining	Lack of security, business risk, business concept not well developed	Credit line Capacity building	**Possibly in future**
LFC	8% of portfolio loans =< MK1.0 million (USD 7,767) 17% MK 1 million (USD 7,767) and MK 2.5 million (USD 19,418) 53% between MK 2.5 million (USD 19,418) and MK10 million (USD 77,671) 22% > MK10 million (USD 77,671)	95% Urban 5% Rural	Agricultural Sector	-Legal system not conducive -Political interference -Lack of credit reference bureaus -Economic hardships - people to own fewer assets and cling to old assets longer -Poor repayment culture but improving -Restrictive tax regime e.g. high VAT rate of 17.5% on assets purchased	Credit reference bureaus Cheaper source of funds e.g. we used to have external lines of credit Physical infrastructure to access rural areas - roads, telecommunications, etc.	**Yes**
MUSCCO	All loans to SACCOs mostly concentrated in MSME	40% Urban 60% Rural	Cooperative Infrastructure Development Livestock production and diary processing Agro processing	-High default rate -Insufficient loan capital -Poor marketing and transport system - poor access to markets -Inadequate pricing for agricultural produce vis a vis cost of production	-Increased line of credit to meet available demand -Institutional Capacity building in terms of training of human resource involved in lending and supply of commodities to facilitate disbursement and monitoring of loans granted.	**Possibly**

B. POTENTIAL DCA GUARANTEES – MEDIUM TERM

Many of the financial institutions interviewed and surveyed during the information collection phases of this assessment expressed demand for a credit enhancement tool such as DCA to help them mitigate risk on lending to certain types of clients. Some of the institutions had very specific ideas about how DCA could be applied, and others were in the preliminary stages of developing strategies for expanding MSME and/or agriculture credit.

As discussed in Chapter Three, one of the key findings of this DCA feasibility assessment is that none of the microfinance institutions or NGO microcredit providers would be suitable DCA partner lenders in the near term. Additionally, while there are some successful individual SACCOs, most are currently so small that it would not be cost-effective for USAID to work with them on a direct basis. However, a guarantee to support MUSCCO's function as the SACCO apex lender is proposed.

Tables 6-2 and 6-3 summarize the most promising guarantees for the mission's consideration for FY 07 and the medium term, according to the information collected during this assessment. Follow up on each is required, as outlined in the two tables presented in Chapter Five, Design and Development Process. Additionally, during that design phase, USAID/Malawi will need to consider its strategy for implementation to encourage active use of loan portfolio guarantees by partner lenders to make loans target borrowers, and to conduct development and financial monitoring on any type of guarantee established to ensure sustainable results.

Table 6-2: Promising DCA Loan Portfolio Guarantees – FY 07 and medium term

Financial Institution	Interest in Target Sectors	Proposed Products / Usage	Comments
Opportunity International Bank of Malawi	Microenterprises SMEs Agriculture	-longer term (3-4 years) loans for smallholder tea growers to upgrade stock or begin planting -expanded lending for paprika and other food processing -expand lending in dairy and groundnuts -individual microloans (as opposed to group loans) in secondary cities and rural areas	-Indicated readiness for FY 07 -Proposed very specific uses for DCA guarantee -Looking at rural outreach and market penetration of poorer borrowers -Strong management, good asset quality
Leasing & Finance Company, Ltd.	SMEs Agriculture	-SME retail leasing -leasing agricultural equipment for dairy farms, tea, and other subsectors, and related transport -expanding leasing to areas near Mozambican borders	-Anticipated ready for FY 07 -Not subject to RBM reserve requirements, therefore good amount of capital to extend -Leasing gets around the issue of MSMEs not having sufficient collateral
MUSCCO	SACCOs Micro and small enterprises	-Extend more credit (as wholesaler) to SACCOs, including rural SACCOs and for longer term	-Anticipated ready for FY 07 -Indiv. SACCOs have expressed demand for medium to long term loans to finance members and their own expansion -Builds institutional strength and sustainability -Need to evaluate whether MUSCCO has sufficient capital for onlending or if it would benefit more from a LG/PG structure
NBS Bank	Agriculture Microenterprises SMEs	-looking at tea, coffee, and cotton -smallholder input finance if grouped (i.e. NASFAM) -developing SME products including lease-backs	-Anticipated ready FY 07 -Submitted letter expressing interest in guarantee facility to DMS -has COMPASS funds for lending to natural resource based enterprises -Will participate in IFC MSME lending program -Testing new sectors
Nedbank	Agriculture Larger exporters (may be part of value chains)	-tea, coffee, cotton, groundnuts -cassava (see Warm Heart below) -in discussions with NASFAM and exporters -longer term interested in lending against warehouse receipts	-FY 07 could be partner lender for Warm Heart LG/PG (see below) -FY 08 potential partner lender for SME and other agriculture -FY 09 warehouse receipts
First Merchant Bank	SME Agro-processing Transport	-SME retail lending	-projecting 7,000-10,000 new clients with IFC support -parent company of Leasing & Finance Co.
National Bank of Malawi	SME	-SME lending and leasing with TA support from IFC MSME lending program	-Possibly ready FY 08 -Active participant in DMS programs -Expanding into SME market

Table 6-3: Promising DCA Loan/Portable Guarantee Guarantees – FY 07 and medium term

Project	Potential Borrower(s)	Estimated Project Amount	Loan Type/Term Required	Potential Lenders	Comments
Starch Extraction Factory	Warm Heart Food Co. or similar private sector entity	Seeking $5 million debt financing total	Guarantee could cover smaller portion, for instance $2 million for working capital, transport, etc.	Nedbank, FMB, LFC (for portions req. leasing)	-FY 07 -A number of lenders keen on Warm Heart, but if financing falls through because of limited security, a LG/PG could be the extra enhancement needed. -Supports USAID and FAO projects supporting cassava.
Dairy Breeding Farms	Medium to large sized companies	Approximately $1 million per project (estimated by Land O'Lakes)	Medium to Long Term (USD)	Nedbank, FMB, LFC, National Bank	-Medium term – projects not structured
Commercial dairy farm with onsite processing and feed mixing	CP Feeds, or similar private sector entity	$1 million (estimated by Land O'Lakes)	Medium to Long Term (USD)	Nedbank, FMB, LFC, National Bank	-Medium term – projects not structured

C. POTENTIAL DCA GUARANTEES – LONGER TERM

Some of the longer term prospects for USAID/Malawi's use of DCA guarantees to support MSME finance include, but are not limited to:

Warehouse receipts financing. USAID/Malawi could use DCA to support the development of a warehouse receipts financing system to complement the work of the World Bank and Ministry of Agriculture Food Security Joint Task Force (FSJTF) in planning for ADMARC's transition to private management. This would most likely be structured as one or multiple loan portfolio guarantees.

Commercial financing of MFIs. Once the MFIs and commercially oriented NGO microcredit providers are strengthened by programs such as DMS, DCA guarantees – most likely loan guarantees or portable guarantees – could be considered to enhance a loan from a commercial bank or other larger financial institution or fund to an MFI. Unlike other donor guarantees discussed, since DCA will only cover up to 50 pecent of a lender's risk, the lender would actually need to evaluate the MFI and its portfolio as part of its credit analysis, and using DCA to support the initial credit transaction would assist the MFI in establishing its credit history.

Sector strengthening. The mission could consider DCA guarantees to stimulate private sector lending to particular high growth or high export potential sectors through one or multiple loan portfolio guarantees.

Microleasing. As MFIs become stronger through investment by USAID and other donor efforts, new product development can expand beyond the basic group and individual loan products to meet a greater variety of microenterprise financial services needs. DCA guarantees could support the introduction of microleasing in Malawi: microleasing is designed to meet the needs of agricultural microenterprises that cannot come up with sufficient collateral on their own to lease equipment. The lender retains ownership of the asset until all installments are made.

Additionally, USAID/Malawi could consider DCA to support other Strategic Objectives or SEGs in its portfolio. DCA has been used to stimulate private sector credit in a variety of technical areas including health, education, municipal development, infrastructure, energy, and environment in addition to MSME finance and agriculture.