Innovations in Microfinance

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This series showcases innovative microfinance programs from the February 2000 "Advancing Microfinance in Rural West Africa" conference held in Bamako, Mali. The programs emphasize reaching new frontiers in rural areas, particularly in West Africa. These notes are an investigation of innovative practices working in specific environments, not a general endorsement of financial products. We recommend institutions utilize these technical notes as introductory information. To learn more about this topic and its applicability to your program, please consult the bibliography at the end of the piece.

Public and Private Investments in Microfinance: A Look at Guarantee Instruments

I. Introduction

In several African countries, economic reforms are beginning to create a more stable and attractive environment for private investment. Some of Africa's financial markets are expanding and deepening, providing more economic opportunities for its citizens and helping alleviate the poverty that has long plagued the region.

Currently, a pressing concern for governments and international donors is to bring commercial financial institutions into microfinance by developing linkages between the formal banking system and non-banking institutions that lend to the self-employed poor, who account for more than 50 percent of the gross domestic product in African economies. Credit is often the best means to leverage private funds for development purposes. Unlocking formal sector resources for use by microenterprises can reduce these economies' vulnerability and enable the self-employed and rural poor to sustain the economic activities that are essential to their survival.

There is no single solution to the problem of expanding financial services throughout Africa. Each country will have to adapt and innovate within the opportunities provided by its economic infrastructure, the degree of development of its commercial financial system, and the rural economy's monetization level. Any approach pursued will have to rely on a variety of instruments and tactics such as retained earnings, commercial or donor loans with guarantees or collateral, securitization, bonds, and leveraging of client savings to broaden access and coverage.

This brief focuses on guarantee mechanisms because they continue to play a role in the development finance strategies of many West African developing countries and were the subject of discussion at the conference held in Mali. Guarantee mechanisms encourage banks to lend to certain economic sectors, such as microenterprises, building a link between microentrepreneurs and formal financial institutions.

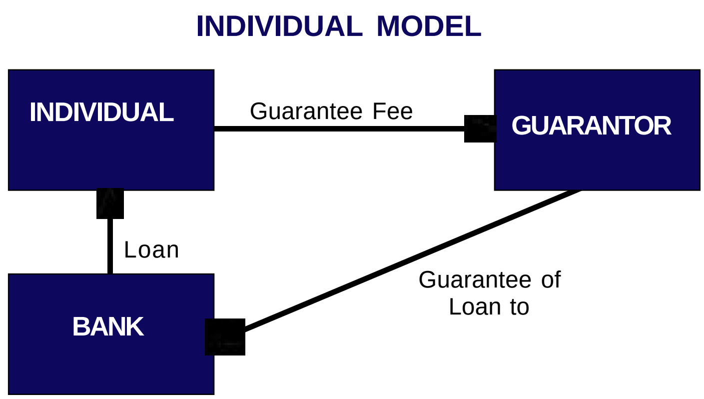
II. What Is a Credit Guarantee?

A credit guarantee is a financial instrument that encourages financial institutions and, in particular, commercial banks to lend to microenterprises that have good prospects of success but are unable to provide sufficient collateral or do not have a suitable record of financial transactions to prove their creditworthiness. The guarantee functions as a promise by the guarantor to the lender that, in the event that the borrower defaults, the guarantor will repay the lender with a specified proportion of the principal foregone. Guarantee entities, either public or private, seek to familiarize banks with the client and, in this process, induce banks to lend to clients that otherwise would not be eligible for bank credit.

III. Do Any Guarantee Models Target The Microenterprise Sector?

Guarantee facilities help start a learning-by-doing process in which banks, donors, non-bank intermediaries, and microentrepreneurs learn to work together. The performance of guarantee schemes is dependant on the model chosen. To date, three types of guarantee models have been used to enhance the flow of finance to the microenterprise sector:

1. **Individual guarantee model:** Under this model, the borrower and the bank are directly linked. The guarantor and the bank establish a cooperative agreement on the degree of risk sharing. The guarantor issues a guarantee agreement or standby letter of credit to the bank. The bank appraises the loan application and, if borrowers fulfill their lending criteria, approves the loan. The guarantee entity, either public or private, is paid a fee for the guarantee by the borrowers, although the bank may collect this fee and pay the guarantor.



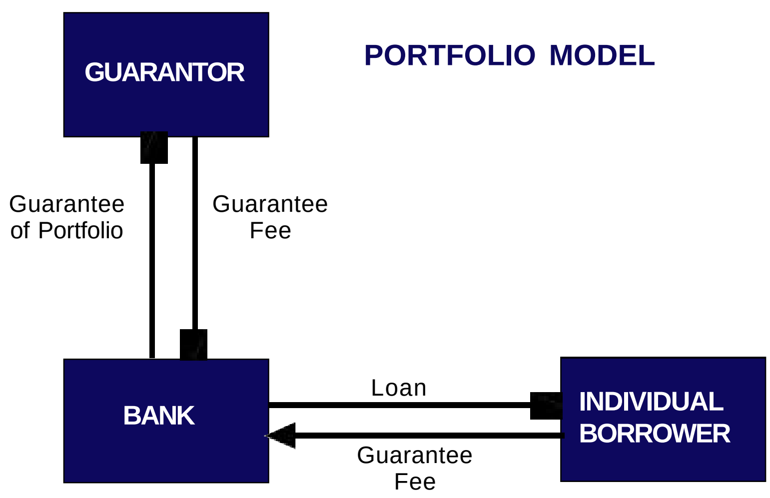
Individual Guarantee Program to Mitigate Structural Adjustment Programs

In Mali, a 50-percent guarantee prompted banks to lend to individually selected clients of the Voluntary Departure Program to ameliorate massive government layoffs. An evaluation, conducted two years into the program, found that only 14 percent of the participants surveyed had applied for bank financing and none had actually received a loan. Two years later, another evaluation revealed that 6 percent of the program participants had applied for loans and, of these, 1.9 percent had received bank loans. Even with the 50 percent guarantee, the banks wanted a sizable equity contribution from the borrowers and collateral in the form of real estate or other securities. This experience clearly conveys how important the guarantee structure is in the program's success or failure. In this case, the loans were too risky for the type of credit and guarantee arrangements implemented.

2. **Portfolio guarantee model:** This model reduces the guarantee entity's involvement with each borrower. Although the individual model requires the approval of guarantees for each loan, under the portfolio model, the guarantor negotiates portfolio criteria with the bank. If the program is for microenterprise borrowers, criteria might include a maximum loan size, number of employees, and other limitations that ensure the borrower is part of the targeted sector. Loans that meet the required criteria are automatically guaranteed and disbursed.

   Experience shows that individual and portfolio guarantees have not been successful in increasing lending to the microenterprise sector because, while the guarantees reduce the risks of lending, they do not address the issue of transaction costs associated with lending to the microenterprise sector.

   For guarantees to encourage banks and other financial institutions to lend to the microenterprise sector, programs will need to reduce the transaction costs to the bank by providing a significant portion of pre- and post-loan business support to entrepreneurs. Because the individual and portfolio models have failed to increase the flow of capital to the microenterprise sector, the intermediary model has



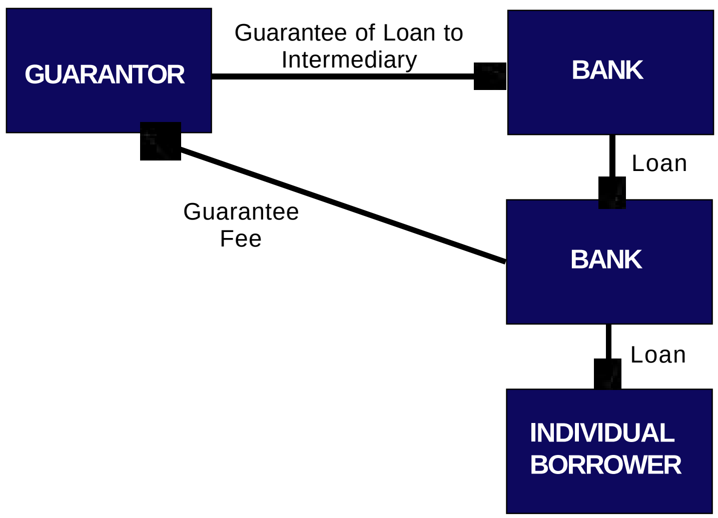
Unlocking Formal Sector Financing for Microenterprise and Small-Scale Entrepreneurs through a Portfolio Guarantee Facility

In 1999, the U.S. Agency for International Development (USAID) set up a loan portfolio guarantee (LPG) program for the Compagnie Bancaire de l'Afrique Occidentale (CBAO) in Senegal. CBAO has emerged as one of the leading banks in Senegal and holds nearly half of its portfolio in the micro and small enterprise sector. CBAO has achieved its success in a challenging economic environment, demonstrating its ability to address risk management issues while maintaining profitability, and it is well positioned to diversify its banking products and broaden its customer base. The guarantee provided by USAID will cover up to 50 percent of the losses incurred on loans to microenterprises and small businesses, up to a mutually agreed guarantee limit that will not exceed US$3 million, which represents about 8.5 percent of CBAO's net worth. CBAO is the first Senegalese bank to be invited to participate in the LPG program, although others have been targeted. Depending upon the success of this pilot initiative, USAID/Senegal plans to expand the scope of the LPG program to include other local banks.

emerged as a guarantee model for service provision to support emerging microentrepreneurs and smaller businesses.

3. **Intermediary or "wholesale" guarantee model:** This model has been adapted especially for the microenterprise sector. Under this model, microentrepreneurs are separated from the bank's normal risk/transaction costs, which are handled by a specialized lending organization that acts as an intermediary between the bank and the borrower. The intermediary organization undertakes the appraisal, approval, monitoring, and supervising roles. The bank guarantees the loan to the intermediary institution. A number of microfinance networks have been experimenting with this model, including ACCION International, Women's World Banking, and Développement International Desjardins.

INTERMEDIARY MODEL



USAID Furthers the Intermediary Guarantee Model Through Innovative Financial Instruments

As microfinance institutions have become more sophisticated in the use of financial instruments, guarantees and credit enhancement models also have been advanced. An advanced version of the original intermediary model was developed that involves the guarantee of capital market instruments, such as bonds or securitized assets, issued by microfinance institutions (MFIs). Under the Micro and Small Enterprise Development Program, USAID has used innovative financial instruments as guarantees such as coupon bonds for purposes of on-lending to qualified buyers for MFIs like BancoSol, a Bolivian bank that specializes in microfinance.

Banks administer many guarantee schemes, thereby reducing the intermediary organization's costs, which does not become involved in cash operations. Guarantee funds become affected only if the bank makes a claim for loan losses. A guarantee fund can be deposited in an interest-bearing account, thus generating income. In addition, guarantee funds can be easily protected against inflation's erosive effects.

IV. What Are the Major Advantages and Disadvantages of Guarantee Schemes?

Despite the potentially positive effect of guarantee mechanisms, guarantee programs appear to have produced mixed results. Although there is little documentation on the outcomes of guarantee programs, making it difficult to extract conclusive lessons, they have both advocates and opponents. Guarantee program advocates point to a number of potential benefits:

- Building linkages between small borrowers and formal financial institutions;
- Increasing bank financing to reach the microenterprise sector, including downscaling by commercial banks;
- Opening financial markets by giving the banks access to the microenterprise sector;
- Diversifying financial instruments and sources for microfinance institutions; and
- Leveraging scarce donor resources for microenterprises.

Program opponents maintain that these arrangements have high risks and transaction costs that make this type of credit enhancement unsustainable over the long run. Despite the advantages, local guarantee funds in practice tend to remain small and relatively ineffective in their outreach; they can easily become a financial burden for their host if costs do not match revenues. The opponents of guarantee programs point to a number of drawbacks:

- Information gathering, analysis, and monitoring are costly, offering few prospects for guarantee programs to achieve cost recovery;
- The guarantee in some cases diminishes the lender's interest in carefully screening clients and following up on delinquent loans; and
- The distribution of risk is not shared equally among all participants, and this makes it hard for guarantee programs to develop a fee structure based on the risk that each party assumes.

To date, experience with guarantees in microfinance has been mixed; some institutions have failed and others succeeded. Although the participation of banks is a prerequisite for an effective guarantee program, there are other general conditions, such as political, macroeconomic, and social circumstances, that also come to play in the decision of whether a bank will lend to the microenterprise sector. In this uncertain context, there is widespread interest in establishing guarantee fund mechanisms to increase the availability of finance to microentrepreneurs by generating a learning-by-doing process in which banks, donors, non-bank intermediaries, and microentrepreneurs learn to work together.

V. What Are Some Key Criteria for Effective Guarantee Schemes?

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

Even though bank participation is a prerequisite for an effective guarantee program, it alone is not sufficient. Critical design features for guarantee schemes include the following:

- **Loan and guarantee approval process:** The due diligence process associated with information gathering, analysis, and monitoring needs to be structured to minimize duplication and costs.

- **Costs and fees:** Many guarantees are successful in the promotion of use by banks, but less successful in their attempt to lend to the targeted borrowers. It is more effective and less costly for guarantee schemes to use a key set of criteria to target borrowers and approve guarantees rather than to evaluate each individual borrower.

- **Risk sharing:** Risk should be shared among participants so as to minimize the overall required risk premium. There should be an attempt to distribute the risk premium *pro rata* by the entities that are assuming risk.

- **Credibility of the guarantee:** Careful attention should be placed on the fund's capitalization and value maintenance through fees or interest earned, to ensure the guarantee entity's solvency.

- **Guarantees should be temporary:** A time frame should be established for commercial banks and MFIs to bridge existing information and cultural gaps. The

ACCION International's Latin America Bridge Fund: A Successful Guarantee Facility Based on a Gradual Leveraging Strategy

The Latin America Bridge Fund that ACCION International established in 1984 has been funded by loans from a number of foundations, private investors, and religious organizations. This fund operates by providing a guarantee on loans made by local commercial banks to ACCION affiliates. Through gradual leveraging, the Bridge Fund persuades commercial banks to enter into business relationships with MFIs. As a rule, the Bridge Fund guarantees up to 90 percent of the value of first-time loans by commercial banks. Over time, as the relationship between the MFI and the bank develops, the proportion of guarantee drops progressively; in some cases, the guarantee is eliminated altogether. The guarantees are extended only to ACCION affiliates, which in turn are required to meet both financial and non-financial criteria that the Bridge Fund establishes. To date, the results of this guarantee mechanism have been impressive, capitalizing the fund with US$6.6 million. On average, the fund guarantees 50 percent of the commercial bank loans extended to ACCION affiliates. Today, the Bridge Fund is leveraging approximately twice its value in loans made to MFIs (US$13.2 million). Over time, mature affiliates using the Bridge Fund mechanism have become regular and trusted clients of local banks. As a result, the fund has been able to provide letters of credit for additional affiliates.

guarantee should strive to bring the lender and borrower closer together, allowing the MFI to upgrade its capacities and establish a working relationship through successful repayment, thereby bridging the gap over time and making graduation possible.

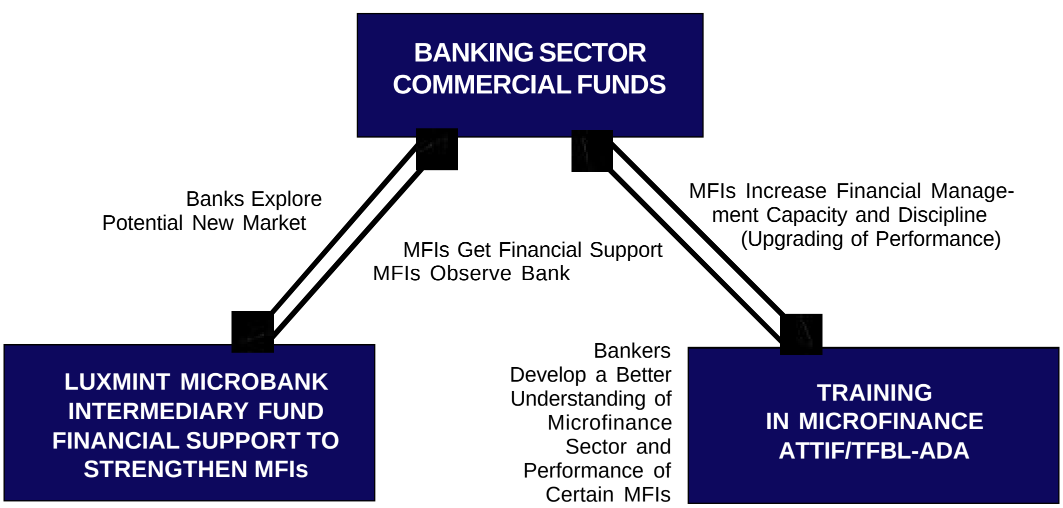
With every loan, banks assume risk and transaction costs. Guarantee funds need to be designed to encourage banks to lend beyond their normal practices or comfort zones. Successful guarantee instruments need to push the comfort zones of banks so that high-risk borrowers become bankable borrowers. As a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

VI. How Do Guarantees Contribute to More Lending and Leveraging?

Guarantees seek to create additional lending by introducing bank financing to clients who otherwise would not be eligible for bank credit. Guarantee facilities use capital as a lever to link banks with higher risk borrowers and obtain additional funds. Leveraging is achieved when banks agree to lend more than the amount guaranteed. Most microfinance guarantees pursue leveraging by guaranteeing different percentages of the loans.

Guarantee funds have become important tools for donors and governments that are seeking to maximize the outreach generated with their resources. Guarantee facilities are used to provide temporary assistance to banks and non-bank intermediaries involved in microlending. The building of some form of equity or reserve is usually attached as a condition for indemnification. As donors progressively withdraw the guarantee facility from the intermediary, the conditionality imposed should steer the intermediary into setting up the new hedging mechanisms that it will need to become sustainable and ensure the guarantee mechanism's success.

A COHERENT APPROACH IN LUXEMBOURG



VII. A Review of Donor and Private Sector Experiences and Innovations

DEVELOPING A SUSTAINABLE GRADUATION PATH

ADA, a Luxembourg-based non-profit organization specializing in microfinance, has mobilized financial resources through guarantee schemes to facilitate the capitalization of microfinance institutions. The organization also created Luxmint MicroBank, an intermediary fund, that was capitalized with government funds. Luxmint offers private investors, especially commercial banks in Luxembourg interested in investing in the microfinance sector, the opportunity to familiarize themselves with the microfinance sector. In 1998, it also established the Dexia microcredit fund, a commercial investment fund specialized in debt instruments issued by microbanks. The objective of the Luxmint guarantee scheme is to offer an interim step for successful MFIs toward direct negotiations of financial resources with the for-profit Dexia microcredit fund. The Dexia fund intends to support the securitization of microbanks' financing and contribute to the development of local capital markets. Dexia is promoting an innovative attempt toward securitization, linking microenterprises with capital markets.

RAISING MEDIUM-TERM CAPITAL FROM LOCAL BANKS

In Mali, the International Finance Corporation (IFC) has processed three partial guarantee facilities for the three leading microfinance institutions in the country: Kafo Jiginew, Nyesigiso, and the Caisses Villageoises du Pays Dogon. The operation reflects the three institutions' importance in Mali's microfinance sector, as together they cover 60 percent of the market share in microcredit and 80 percent in savings. In this case, a partial guarantee structure enabled these MFIs to raise financing from local banks for up to CFAF 1.5 billion (US$2.5 million equivalent). As a result of this guarantee facility, the MFIs have been able to raise medium-term funding from local banks and meet the strong demand requirements from their clientele for medium-term credit. This facility includes a number of innovations:

- **Partial guarantees** involve the local banks on the direct credit risk associated with MFIs, ensuring ongoing supervision and leading to future bank lending without IFC guarantees.
- **Local currency operation reimbursements** were structured in CFA francs, thereby avoiding any foreign exchange rate risk for MFIs and their clients.
- **Simple legal documentation in French:** The legal documents were designed to be easily understood by each MFI's board of directors and management.

With these innovations, the IFC has developed a guarantee product that is tailored to the needs of the institutions' clients and brings commercial banks and MFIs closer together.

USING CAPITAL MARKET INSTRUMENTS AS GUARANTEES

Under the Micro and Small Enterprise Development Program, USAID has made significant progress in building sustainable linkages between financial institutions and micro and small enterprises that lack access to formal financial markets. The Agency has developed an advanced version of the intermediary guarantee model that involves guaranteeing capital market instruments, such as bonds or securitized assets, that microfinance institutions issue. For example, in April 1996, USAID provided a 50 percent guarantee for two 2-year coupon bonds that Bolivia's BancoSol issued worth US$1 million. The success of this facility prompted USAID to issue another US$1 million bond guarantee to Banco Empresarial S.A. in Guatemala and later on another bond to Banco Solidario in Ecuador to continue their pioneering lending work to micro and small enterprises.

SECURITIZING MICROENTERPRISE PORTFOLIOS

Securitization is another innovative attempt to link microenterprises with capital markets by issuing corporate debentures backed and serviced by the microenterprise portfolio. The structure requires the creation of a single purpose corporation that buys the microenterprise portfolio and capitalizes itself by issuing debentures into the capital market. It floats debentures that are enhanced to meet the highest standards of commercial paper, with the equity plus a reserve against loss providing the necessary protection. Securitization allows microfinance programs to access national capital markets with a relatively simple corporate structure. Its main advantages include access to lower cost funds for the microenterprise program without requiring any operational changes. Securitization enables MFIs to reap the benefits enjoyed by formal financial institutions without having to meet the excessive demands of transformation.

BUILDING FULL COST-RECOVERY INTO GUARANTEE FUNDS

The Triad Guaranty Insurance Corporation is one of the many insurers that issues private mortgage insurance to residential mortgage lenders in the United States. Triad has successfully encouraged mortgage lenders through an insurance guarantee to lend to borrowers with collateral constraints. Triad is now in its seventh year of operations and has developed a profitable mortgage guarantee operation with a statutory ratio of less than 60—that is, its losses and expenses are less than 60 percent of its premium income. The company has grown its capital and paid shareholders a dividend in cash and stock. As a private company, Triad does not receive any subsidies. By almost any measure, this company is viable as an ongoing business that has attracted private investors and shareholders. The Triad experience may be feasible in the field of microfinance.

VIII. Conclusions

As experience has shown, establishing a credit guarantee program does not guarantee its success in reaching the microfinance market. However, credit guarantee programs do offer some innovative methods to expand microentrepreneurs' access to capital. Graduated lending schemes, guarantees of capital market instruments, sustainable non-profit funds for microenterprises, and the use of partial guarantees to raise medium-term capital from local banks have shown some success where key criteria are in place and there is an enabling environment for guarantee funds to function effectively. Guarantee funds are not a solution to the inherent risk related to any financial operation but provide an excellent instrument to spread the risk among different actors, promoting innovation and diversification toward new product and client segments. The challenge for donors and banks alike is to craft a guarantee fund program using lessons learned, monitor and track its performance, and make adjustments so that it reaches the targeted clientele.

IX. Glossary

Collateral: Property pledged as security for the satisfaction of a debt. Collateral is additional security for performance of principal obligation.

Collateral substitute: A pledged good, right, or title that is neither marketable nor legally enforceable but works as an incentive, screening, and sanction mechanism to ensure debt repayment.

Debentures: A general debt obligation that is backed only by the integrity of the borrower. An unsecured bond is a debenture.

Guarantee: An agreement in which the guarantor agrees to satisfy the debt of another (the debtor), only if and when the debtor fails to repay (secondarily liable).

Leverage: Leverage is the use of capital to increase the return possible. For example, an institution may place $50,000 in capital on deposit to borrow $100,000; this also is known as a loan guarantee for lending to microentrepreneurs, in which case they have leveraged their capital two to one.

Line of credit: A line of credit is an expression by a lending entity of the maximum amount it is willing to lend to a particular customer over a future length of time. This amount may be borrowed in more than one draw down, without submitting a new loan application.

Reinsurance: A promise that an institution makes to assume part of the default risk on already guaranteed loans.

Risk premium: Extra interest paid to a lender, over amounts usually considered normal, in return for its engaging in activities more risky than normal.

Risk-sharing agreement: An agreement to share the risk of loan defaults between bank and guarantor.

Security: An obligation, pledge, mortgage, deposit, or lien given by a debtor to ensure the payment or performance of the debt, by furnishing the creditor with a resource to be used in case of failure in the principal obligation**.**

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