USAID
FROM THE AMERICAN PEOPLE

LOAN GUARANTEES

EXAMPLES AND LESSONS LEARNED

SEPTEMBER 2005

LETTER OF INTRODUCTION FROM USAID'S ADMINISTRATOR

Private banks in developing countries are sitting on significant amounts of capital that could be invested in local development, but often, these banks are reluctant to lend to clients and enterprises that they believe are too risky. As a result, creditworthy borrowers and potentially creditworthy and highly beneficial projects find it difficult to impossible to get necessary financing. Whether they are farmers in Croatia who want to improve crop production or a town in the Philippines that needs to build pipelines to deliver clean water to local residents, access to capital from the private sector is essential.

With my encouragement, the United States Agency for International Development (USAID) started to aggressively use a new mechanism to mobilize private capital in less developed countries. That mechanism, the Development Credit Authority (DCA) is a tool that enables USAID to offer partial guarantees to private banks to encourage lending where access to credit is limited or unavailable. By sharing the risk with financial institutions and investors, we create alliances that support lenders while exploring new markets and analyzing the risks of new investments.

This guide demonstrates in detail the significant impact our guarantees are having around the world. Today, USAID guarantees are stimulating new and increased investments in micro and small business, infrastructure, health, energy, agriculture and education. The guide also provides helpful details to use when designing your own projects with DCA. Coupled with USAID's technical assistance and policy reform efforts, our guarantees have, for example, enabled microfinance institutions in Peru, Morocco and South Africa to receive loans from local banks to provide services to thousands of new clients.

USAID is a leader in the development finance community actively mobilizing private capital in developing countries. Following our example, other donors and development banks are now exploring ways to use their own resources to mobilize local financing. To date, our guarantees have established 124 public-private partnerships and generated $921 million in loans from private banks to local borrowers. This work is a key step in the success of the Agency's development objectives and to the broader goals of the Millennium Declaration.

Our partial guarantees are invaluable to our economic development mission. The examples in this guide will serve as a useful reference to learn how USAID's guarantees can be adapted to different environments and assist us in reaching our goals.

We continue to find new and innovative ways to use DCA, and I encourage you to do the same.

Andrew S. Natsios

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INTRODUCTION

Borrwers in many develop ing countries have long faced the same challenge— how to access credit to finance a new or growing business. This issue comes up time and again in rural communities and urban areas around the world as micro, small and medium-sized businesses, municipalities and other entities look for reliable sources of private capital.

One major factor limiting the availablilty of credit from the private sector is its aversion to risk. This reluctance to lend is often based on the *potential* for loss lenders associate with funding a particular activity. Whether it is a new type of investment or one that was unprofitable in the past, many financial institutions and investors are not lending where the need is great and where credit-worthy borrowers and projects exist.

The circumstances that limit access to credit, or market imperfections, as they are sometimes called, are common across banking systems, regions and countries. Whether the risk is real or perceived, the results are frequently the same: the private sector is not lending to that sector, area, or type of activity, or if they are, collateral requirements are beyond what borrowers can provide, or loan terms are shorter than what borrowers need.

The owners (husband and wife pictured in the center) of this small market in Kenya used a USAID-guaranteed loan from K-Rep Bank to expand the products offered to shoppers and open a new store in a nearby town. Photo: USAID/Kofi Owusu-Boakye

PURPOSE OF GUIDE:

The purpose of this guide is to provide select examples of how the U.S. Agency for International Development (USAID) uses partial credit guarantees to engage private financial institutions in extending credit to these areas and projects.

USAID LOAN GUARANTEES—

USAID partial credit guarantees enable the Agency to reduce lenders' risk by sharing the potential for loss on new investments to particular development -related areas or projects. These guarantees complement the Agency's work across a range of sectors such as water, health, education and trade, and under a variety of circumstances to promote private investments in development.Four types of partial guarantees are available to cover the private sector's new or expanded investments. (For more information on each type of guarantee, see page 47.)

EXAMPLES FROM THE FIELD

The examples on the following pages highlight successful uses of USAID guarantees and some of the most common limitations to accessing credit. Each example demonstrates how a USAID mission has used a guarantee either alone and in conjunction with other forms of assistance, including training or technical assistance, to support their development objectives and increase private-sector lending despite conservative banking practices.

Although partial guarantees can operate as stand-alone credit enhancements, USAID guarantees are most effective when used to complement Missions' technical assistance. Pairing this assistance, which is often multi-year development work in, for example, legal and institutional reforms, with a tool that engages the private sector in lending to these areas helps ensure the necessary environment exists for that work to be sustainable.

The ability of borrowers, whether they are small and medium-sized businesses, microentrepreneurs or municipal entities, to access private sources of credit is key to a number of development objectives, including reducing poverty, improving local services, and creating economic growth. Providing private lenders with an opportunity to invest where credit is unavailable or too expensive enables them to gain the experience and build the skills to encourage lending beyond USAID's assistance.

(For more information regarding factors that effect borrowers' access to credit refer to Appendix II at the back of this document.)

INTENDED AUDIENCE

This guide is intended to serve as a reference for missions considering the applicability of a partial credit guarantee to support their strategic objectives. It is also intended for missions already using a guarantee, as supplemental information when considering new partnerships or development initiatives.

SELECTION CRITERIA

Each example was chosen from among approximately 110 active guarantees. Below are the major criteria used to determine which guarantees to highlight in this guide.

1 Provides at least one example of each type of USAID-guarantee;

2 Already has loans under coverage;

3 Addresses particular market imperfections—by demonstrating good uses of a guarantee in situations where common limitations to financing exist;

4 Illustrates the impact of the loans to the borrower(s) and where possible, to the borrower's(s') broader lending community;

5 Identifies how access to credit helps achieve important development objectives and, where applicable, impacts the local financial sector;

6 Demonstrates the potential profitability of lending to a particular underserved area or undeveloped activity;

7 Complements USAID technical assistance already in place supported by additional assistance packaged with a partial guarantee.■

LENDING TO SMALL & MEDIUM AGRIBUSINESSES

NICARAGUA – LOAN PORTFOLIO GUARANTEE - 2002

In Nicaragua, agriculture dominates the national economy, as it does in many other developing countries. It is the major source of income for over 40 percent of the population and a key source of economic growth for the country. To develop the sector, and the agribusinesses that are critical to it, borrowers need sustainable access to credit and greater investment from private financial institutions in local operations.

Country Background—
In Nicaragua, decades of trauma from natural disasters, civil war, and banking crises have wreaked havoc on the country's economy. For ten years, beginning in 1990, a series of catastrophic natural events coupled with two banking sector failures undermined Nicaragua's financial stability and substantially increased the country's national debt.

By 2002, although the economy had stabilized and was enjoying positive growth, only six commercial banks were still in operation.

WHY WAS A LOAN GUARANTEE NEEDED?

The banking environment that developed as a result of over a decade of volatility has made Nicaragua's investment climate difficult for both private lenders and local borrowers.

One of several local challenges is the increasingly conservative lending practices of commercial banks. Over time, their aversion to risk has manifested in the decreasing number and size of new loans and virtually non-existent financing available to non-traditional sectors such as agribusiness.

An additional and significant hindrance is the absence of borrower credit histories. The lack of credible information on an individual's ability to repay a loan has forced banks to analyze new loan requests based almost entirely on information presented by the borrower at the time of application. To demonstrate creditworthiness, borrowers have to provide a busines plan, documents of the cash flows from their busines, and proof of collateral, such as personal financial statements (indicating the borrowers personal wealth, including all assets).

Banks are unwilling to lend solely on the basis of a business' current and future cash flows, even if the business consistently operates at a profit. Instead, banks rely heavily on a borrower's ability to provide collateral to cover any potential for loss with each new loan. The level of collateral required is determined in-house by each bank and calculated based on the potential risk associated with each loan. The resulting collateral required for the new loan often exceeds 100 percent of the loan principal, even for short-term lines of credit. These requirements surpass the total assets of many, if not most borrowers, including agribusinesses, especially smaller operations.

These market inefficiencies and restricted flows of capital have made it virtually impossible for many creditworthy borrowers to access private-sector financing. Banks simply will not lend without the ability to take possession of valuable assets or highly liquid securities.

To improve the potential for Nicaraguan agribusinesses to develop a financial relationship with the local banking sector, the USAID Mission in Nicaragua chose to offer a partial credit guarantee. The availability of the guarantee was a way to test the banking sector's general interest in entering a new market, and if successful, would demonstrate the profit potential of lending in that market.

USAID/Nicaragua held several meetings to determine the most appropriate structure for the guarantee. The original concept was to partially cover up to $20 million in new loans to small and medium-sized enterprises from five banks (three commercial and two microfinance providers). After further discussions, concern arose that such a large effort, especially as the Mission's first use of a guarantee, would over-extend staff and budget resources. As a result, the Mission chose to structure the guarantee as a pilot to engage one private commercial. USAID would share the risk on up to $5 million in new loans to agribusinesses operating in three select categories of trade (see diagram on next page).

The added security of a partial guarantee was intended to increase the bank's comfort in lending to borrowers for agriculture-related activities and help the financial institution gain enough experience to continue lending without the need for guarantees in the future. Instead, to promote greater private-sector investment in Nicaraguan agribusinesses and as a result of its continued lending in the sector, would entice other banks to enter the market and make similar loans.

GUARANTEE TERMS

Agriculture and Aquaculture	Nicaragua – 2002
Type of Guarantee	Loan Portfolio Guarantee
Guaranteed Party	Banco Centroamericano de Crédito, S.A. (Bancentro)
Borrowers	Small and medium-size agribusinesses involved in value-added products, aquaculture and light manufacturing
Maximum Amount of Portfolio	US$5,000,000
Amount fully Guaranteed	US$2,500,000 or 50% of total portfolio
Level of Guarantee Coverage	50% of principal
Term of Coverage	5 years
Currency of Loans	US Dollar and Nicaraguan Cordoba

HOW WAS USAID'S CREDIT GUARANTEE USED?

USAID/Nicaragua identified five banks as potential partners. To select one, the Mission visited and held meetings with each bank to determine their level of interest in lending to export and agriculture-related small and medium-sized enterprises.

One of the institutions, Banco Centroamericano de Crédito, S.A. (Bancentro), whose clients were mostly large operations and well-established individual and corporate borrowers in other sectors, was interested in diversifying its loan portfolio. A prominent local commercial and retail lender, Bancentro's portfolio was heavily weighted in construction projects and loans to large companies. The bank had the largest regional lending activity of all the banks considered by the Mission, as well as the most progressive management. In addition, Bancentro's objectives were similar to the Mission's. After a formal analysis of Bancentro's financial statements, management and credit options, it was chosen as the lender for the proposed guarantee.

Despite the banking sector's challenging past, Bancentro wanted to explore new markets and new investment opportunities. An increase in deposits coupled with the bank's conservative lending practices had significantly increased Bancentro's liquidity, i.e. it had a large amount of capital on hand.

The bank's strategy was to expand the scope and size of its lending operations by expanding its existing financial and risk assessment capabilities without sacrificing client service or the quality of its credit analysis.

Although the bank had previously invested in the sectors targeted by USAID, the guarantee allowed the bank to lower its collateral requirements and increase the number of loans made by clients that were previously denied credit due to insufficient collateral.

USAID/Nicaragua believed that targeting loans to agribusinesses focused on primary exports, value-added products, and aquaculture/fisheries (described in the diagram above) would increase production capacity and product diversity by providing the necessary capital for new machinery, additional staff and more production inputs.

A leading Nicaraguan shrimp producer, for example, was unable to secure financing from local commercial sources despite a steady stream of hard currency revenues over several years and a proven demand for shrimp in the export market. Other firms in related industries had similar experiences despite positive cash flows and the ability to repay their loans.

Bancentro wanted to use the guarantee to help these types of borrowers when they did not have enough collateral to meet the bank's requirements, and to give the bank exposure to higher-risk investments. Besides reducing its collateral requirements, the bank was also was willing to tailor financing and extend loan terms to incorporate the new types of loan requests they anticipated receiving.

Although USAID/Nicaragua did not provide direct technical support to the bank, a USAID/Nicaragua program, "Partnership for Food Industry Development", managed by Michigan State University, worked with the same types of local small and medium-sized enterprises and benefited some of its participants who were able to establish a relationship with Bancentro and obtain credit as a result of USAID's technical assistance and the presence of the guarantee.

Relationships such as these, which may have previously ended quickly due to Bancentro's reticence to lend to agribusinesses, instead have benefitted both groups.

One particular beneficiary of USAID's techical support was Sebastian Araya, the owner of a medium-sized melon farm. Mr. Araya wanted to diversify his farm's production by growing okra, a vegetable used in soups and stews, to sell in the United States during the winter when U.S. producers cannot meet the demand.

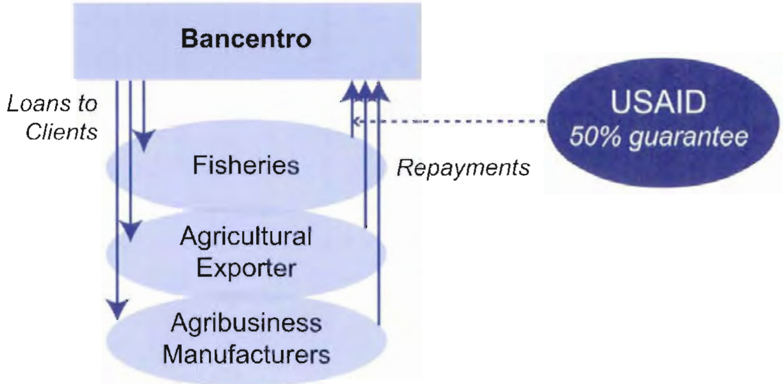
Mr. Araya had approached several banks for a loan but was unsuccessful in obtaining credit to cover the costs of expanding his business. Through his involvement with the Partnership for Food program, Mr. Araya was encouraged to apply for a loan from Bancentro. The loan would cover labor, much needed supplies, such as seed, and the packaging shed where the newly-harvested okra could be sorted, washed and packed. With USAID's guidance, Mr. Araya was able to borrow $70,000.

The guarantee gave the bank the confidence to make new loans.

Mr. Araya would not have received his loan without USAID's work and the motivation the guarantee provided in helping Bancentro consider agribusiness borrowers as potential clients.

Since banks pay a small fee on all loans put under coverage of a USAID guarantee, it is in the interest of each bank to determine which borrowers have strong enough backing, including technical assistance and other external support, to necessitate or forego the guarantee's coverage.

In Mr. Araya's case, Bancentro chose to forego coverage for the loan and took on the entirety of the risk itself due to its confidence in his ability to



repay following the support he received from USAID. Mr. Araya proved to be a creditworthy borrower and has already repaid his loan.

WHAT WAS THE IMPACT OF USAID'S GUARANTEE?

As a whole, the experience has been a huge success for Bancentro and USAID. Although it had made a few loans for agriculture-related projects, on its own, Bancentro had not fully entered the sector nor moved down market from lending to large businesses to making loans to smaller enterprises until it received USAID's guarantee. The bank's willingness to lend and the effectiveness of its lending practices have had several significant results.

Private Sector Loans Made to Smaller Agribusinesses

Despite being designed to cover loans to small and medium-sized agribusinesses over a five-year period, Bancentro felt confident enough to disperse all $5 million within the first two years with no defaults recorded to date. In addition, based on information provided by the bank, USAID/Nicaragua estimates that of the $5 million Bancentro originally intended to lend, as a result of the guarantee, total loans to agribusinesses were well over US$6 million.

New Lending Experience for Private Bank

USAID's partial credit guarantee provided the right incentive for Bancentro to enter a risky sector. As a result of the number and diversity of loans made, Bancentro has demonstrated to Nicaragua's financial community that despite volatility in the sector, small and medium-sized agribusinesses involved in growing, processing and manufacturing export products can be creditworthy borrowers.

Agribusinesses benefitted directly from the magnified amount of financing available to them for their operations. Since 2003, over 57 borrowers have received loans from Bancentro supporting businesses ranging from cattle ranching to potato farming, for the purchase of new and additional inputs, machinery, and technical support.

The presence of USAID's credit guarantee lowered Bancentro's level of risk enough to support it in entering the agribusiness sector. As a result, Bancentro felt comfortable reducing its collateral requirements, substantially increasing the number of eligible agribusiness borrowers it could take on as clients. Of the 57 borrowers mentioned above, 76 loans were made under coverage of the guarantee and almost half were to new clients. In some cases, clients that provided full collateral under the guarantee have since been able to access new loans without presenting additional assets as collateral.

Bancentro sees its new lending experience with USAID as an excellent partnership, demonstrated by the positive repayments and expanded length of loans to many of the borrowers under the guarantee.

Some borrowers who successfully repaid short-term loans of three to six months have subsequently received increasingly longer-term loans, up to five years, as a result of their good repayment history. Over time, these records of repayment have demonstrated agribusinesses to be creditworthy borrowers and good investments.

Local Community Benefits— The loans provided by Bancentro have created a ripple-effect of benefits across a broad set of social issues. Both employment and standard of living have been positively affected by the hiring of additional labor, for example, to work on borrowers' peanut, potato and rice farms. The purchase of new machinery has increased production and shortened the processing time for agricultural products. It has also created the desired link between agribusinesses and the financial sector by demonstrating smaller agribusinesses' ability to repay their loans, as well as to manage more than one loan at a time.

New Financial Resource for Borrowers— At the beginning of the

Sebastian Araya Sr. and his family surrounded by okra at their farm in San Benito, Nicaragua. Photo: USAID/Jan Howard

"USAID helped me establish a direct market link with a Miami-based vegetable wholesaler to export my okra crop. With a free trade agreement, I'll have more options for buying production materials that could lower my costs and I'll have a U.S. market for my okra. I'm not worried about competition. I've received help from USAID to improve my production. I know I have a high quality product."

- SEBASTIAN ARAYA SR.

program's design, USAID/Nicaragua could have chosen to provide grants directly to individual businesses or to a particular bank to use as a revolving fund for specific borrowers, but neither option would have involved the bank's capital. By chosing, instead, to use a partial guarantee, USAID shared the risk with Bancentro on a 50-50 basis, effectively creating a sustainable financial link between the private sector and local agribusinesses and creating a market for private sector investments.

Developing this access to credit was particularly timely for Nicaragua, which was anticipating joining the Central American Free Trade Agreement to open the country's opportunities for economic growth.

Based in part on the success of Bancentro's guarantee, USAID/Nicaragua now has six guarantees with various private-sector financial institutions covering the development of other small and medium businesses, as well as cleaner production and health-related work.

LESSONS LEARNED

USAID/Nicaragua's success with this pilot encouraged the Mission to develop another guarantee. Initially, the second guarantee was offered to Bancentro to expand on the success of the first and boost lending to other small and medium-sized businesses.

During its development, a question came up regarding whether a second guarantee to the same lender for virtually the same activity complied with one of USAID's guiding principles for its credit guarantees. This principle, known as "additionality", states that a guarantee can only be established to cover loans that would not be made without it.

While the issue was being deliberated, Bancentro. Inadvertently addressed the Mission's concern when it withdrew from further negotiations citing a reluctance to pay the origination and utilization fees.

In retrospect, the Mission understood that Bancentro's partnership with USAID and experience with agribusinesses taught the bank what it needed to continue lending to the same types of borrowers on its own— eliminating the need for a second guarantee. ■

ACCESS TO CREDIT BOOSTS ENERGY EFFICIENCY

BULGARIA – LOAN PORTFOLIO GUARANTEE - 2002

The impact of energy use on the environment is a worldwide issue. While demand for energy increases on a global scale, in Bulgaria, local businesses and municipalities lack access to adequate private financing to implement projects that would help them use or produce energy more efficiently. Consequently, while the negative impact of Soviet-era systems continue to burden the environment, industrial and municipal operations lose out on significant cost-savings from modern systems and newer technologies.

In an effort to help Bulgaria develop competitive private enterprises, that benefit from these efficiencies and an economically sustainable, environmentally sound energy sector, the USAID Mission in Bulgaria has been working with the public and private sectors to promote implementation of energy-efficiency projects. improve access to credit for projects that reduce the negative impact to the environment,

Country Background—
During the 1990's, Bulgaria's emergence from communism and transition to democracy were marked by social and economic unrest that culminated in a severe economic and financial crisis from 1996-1997.

The International Monetary Fund (IMF) responded by proposing reforms to reduce inflation and stabilize the economy. In meetings with the Bulgarian National Bank, Balgarska Narodna Banka, the IMF suggested increasing the percentage of cash reserves provisioned on outstanding loans. The larger reserves would reduce the negative impact on banks in the event of a financial crisis. In addition, the IMF pushed for privatization of Bulgaria's state-run banks.

WHY WAS A LOAN GUARANTEE NEEDED?

One challenge created by these reforms was the difficulty borrowers faced in obtaining credit, despite its importance in stimulating the country's economic growth. Private commercial banks had little interest in lending to nascent sub-sectors like energy efficiency, or to municipalities that could not show an immediate return on their investment.

The one or two financial institutions that made loans for similar projects were reluctant to provide additional and longer-term financing of over a year in length, despite most projects development cycle, which typically requires financing for up to five years. The few energy-efficiency projects that had been successfully financed did not provide enough incentive to interest other banks in making similiar loans.

To reduce these constraints, USAID/Bulgaria decided to use a partial credit guarantee to demonstrate the profit potential of private-sector financing for energy-efficiency improvements. The guarantee would complement USAID's work

Such energy-efficiency projects would not only improve the environmental impact of older municipal facilities, they would also lower operating costs and improve service delivery.

supporting the country's legal and fiscal decentralization and more competitive, market-oriented systems.

Energy-efficiency projects would not only decrease the negative environmental impact of Bulgaria's old municipal facilities, they would also lower operating costs and improve service delivery. Achieving greater efficiencies in municipal facilities like schools and hospitals would have widespread social and economic benefits. The cost savings, for instance, would enable municipalities to devote more resources to other public services.

HOW WAS USAID'S CREDIT GUARANTEE USED?

In late 1999, USAID/Bulgaria approached six local private financial institutions involved in the energy sector to find a lender that might extend credit for energy-efficiency projects. USAID met with mid- and high-level management to present the Agency's new partial credit guarantees and explain their use in reducing the risks in providing energy-efficiency loans. Few of the banks, for example, were aware that energy-efficiency projects are one of the few infrastructure-related investments that, by producing immediate energy costs-savings, have payback periods well within lenders' typical requirements.

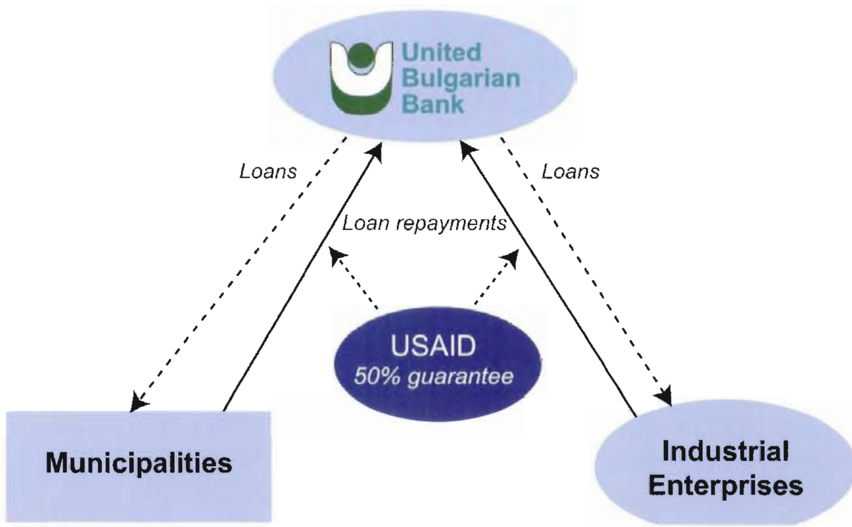
Of the three banks that initially expressed interest, United Bulgarian Bank (UBB) the country's second largest bank, with 58 branches, and one of the first to be privatized in the country, was chosen to receive a partial guarantee.

GUARANTEE TERMS

Energy Efficiency	Bulgaria - 2000
Type of Guarantee	Loan Portfolio Guarantee
Guaranteed Party	United Bulgarian Bank (UBB)
Borrowers	Creditworthy municipalities, private enterprises
Maximum Amount of Portfolio	US$6,250,000
Amount fully Guaranteed	US$3,125,000 or 50% of portfolio
Level of Guarantee Coverage	50% of prinicipal
Term of Coverage	Seven (7) Years
Currency of Loans	Bulgarian Leva

USAID/Bulgaria designed and structured the guarantee using its municipal energy-efficiency program (MEEP), an existing project to develop the environment for sustainable commercial financing of energy-efficiency projects. The additional support from MEEP effectively halved the amount of time involved in its design. Instead of the normal six- to twelve-month guarantee development process, the Mission negotiated the terms of the guarantee agreement with UBB (from concept to the bank's payment of the origination fee) in five months. The Mission's speed in identifying the lender, structuring the guarantee and satisfying USAID information requirements enabled it to access special one-time funding for energy-related programs. These funds were used to pay the guarantee's subsidy cost (a budgetary expense Missions incur to establish a guarantee).

The UBB began using the guar-



The new bottling line at Pirinsko Pivo Brewery, purchased using a loan from UBB, is a great improvement over previous technologies. It uses energy more efficiently, reduces overall energy consumption and virtually eliminates production faults.

antee by providing lines of credit to two classes of borrowers: large municipalities and private-sector industries. Of approximately 237 municipalities in Bulgaria, only 26 are considered large enough to engage in sustainable energy-efficiency projects that require substantial financing. These larger muncipalities contain thirty percent of Bulgaria's population. All 26 are part of a network, under MEEP, designed to assist them in identifying, staffing and lobbying for projects that would incorporate energy efficiencies.

Through MEEP, USAID has helped Bulgaria's public and private sectors identify such projects, as well as develop business plans and loan applications for commercial financing. This assistance was part of the Mission's broader goal to expose the country to the benefits of energy-efficiency improvements and more specifically, to develop local expertise in energy-efficiency project development, analysis and evaluation.

USAID's support to potential borrowers and partial guarantee helped UBB feel comfortable enough to expanding beyond the lines of credit to provide commercial loans for up to three years. After some time, UBB then increased the loan terms to up to five years.

Among the loans covered by the guarantee, several were made to private industrial producers including a battery manufacturer and an electro-ceramics plant.

Another was made to Pirinsko Pivo, a Bulgarian brewery, to help the company buy a boiler (see the partial list of borrowers below for more details). The new, more efficient steam boiler increased the brewery's overall energy efficiency by 10 percent and significantly reduced the fuel oil, electricity and water consumption of the factory. Energy costs dropped by 31 percent and production costs went down 6.4 percent. The resulting cost savings enabled the brewery to lower prices on several products. As a result, the company improved its market share and reinvested the

Borrower	Location	Project Description	Project Cost	Loan Amount	Share of Portfolio
			in millions US$		by percent
Pirinsko Pivo Brewery	Blagoevgrad	Industrial	$400,773	$291,646	2.92
Municipality of Silistra	Silistra	Street lighting of Silistra; boiler reconstruction, solar thermal installation	$279,370	$198,073	1.98
Municipality of Sevlievo	Sevlievo	Water utility, boiler reconstruction, street lighting, hospital building retrofit	$323,447	$201,255	2.01
Elprom Elin Electroceramics	Kubrat	Industrial	$109,832	$75,884	0.76
Energia Battery Manufacturer	Targovishte	Industrial	$998,684	$701,557	7.02
Galus Impex Poultry Farm	Russe	Industrial	$778,784	$561,920	5.62
Agropolychim Fertilizers	Devnja	Industrial	$2,296,289	$1,722,217	17.22
Sugar Plants	Gorna Orjahovitza	Co-generation	$1,339,047	$1,035,470	10.35
Municipality	Dulovo	Street lighting of Dulovo and 26 adjacent villages	$133,044	$99,809	1
Nelsen Solid Waste Utility	Stara Zagora	Municipal solid waste collection and transportation vehicles, and city cleaning service	$479,699	$479,669	4.8
HPP "Arnaoutovtzi"	Simitli	Small hydro power plant 0.5 MW	$284,675	$88,136	
Municipal Hospital	Svishtov	Wood briquettes for heating	$186327	$53765	0.54

savings in its operations.

By 2001, these new loans had gained widespread attention in Bulgaria. As local financial institutions were searching for new ways to invest, UBB's energy-efficiency lending could demonstrate the potential for profit from such loans. The UBB was ahead of the market and other banks were taking notice.

With help from a well-organized media event, local press covered USAID's signing ceremony with a second financial partner, Bulgaria's largest commerical bank, First Investment Bank. USAID/Bulgaria's Mission Director and the U.S. Ambassador to Bulgaria spoke at the ceremony and announced the agreement guaranteeing up to US$20 million in new lending to small and medium-sized enterprises (SMEs). The media coverage also highlighted UBB's new energy-efficiency lending resulting from USAID's program, and identified several municipalities already benefitting from UBB's financing.

Within the guarantee's first five years of coverage, the demand for financing from UBB increased from an average loan size of $145,000 for small municipal projects to larger projects needingf $500,000 to $1 million. In addition, a rise in the number of loan requests and excellent repayment records from existing borrowers prompted UBB senior management to consider expanding its loan portfolio.

To manage the new and expanding demands made by its clients, UBB proposed several adjustments to its guarantee with USAID, beginning with a request to lower USAID's coverage on additional loans. The change would reduce USAID's exposure from 50 to 30 percent, and lower both the Mission's and the bank's costs to implement a revised version of the guarantee. Further modifications are listed below:

- an increase in the ratio of private-enterprise to muncipal loans UBB could put under coverage to allow for larger loan amounts requested by private businesses;

- coverage of loans made in Euros and US dollars, in addition to the original currency, the Leva. When currency risks warranted it, USAID's coverage of these currencies would enable the bank to offer more attractive loan terms to borrowers.

Among thirty loans made by United Bulgarian Bank through November 2003, only one loan (for $100,000) defaulted, of which USAID is only liable for $50,000.

GUARANTEE TERMS

Energy Efficiency	Original Coverage 2000	New Terms - 2002
Type of Guarantee	Loan Portfolio Guarantee	–
Guaranteed Party	United Bulgarian Bank	–
Borrowers	Creditworthy municipalities, private enterprises	–
Maximum Amount of Portfolio	US $6,250,000	US $10,000,000
Amount fully Guaranteed	US $3,125,000 or 50% of portfolio	US $5,000,000 or 30% of portfolio
Level of Guarantee Coverage	50% of principal	30% of principal
Term of Coverage	Seven (7) Years	Eleven (11) Years
Currency of Loans	Bulgarian Leva	US$, Euro, Leva

To avoid losing the benefit provided by his new-found access to credit, the only borrower to default approached UBB to discuss alternative payment options. Working with the bank's credit department, he provided additional hard assets as collateral, avoiding total default and the need for UBB to make a claim against the USAID guarantee.

WHAT WAS THE IMPACT OF USAID'S GUARANTEE?

As of February 2004, UBB had lent the $10 million it could cover under USAID's guarantee which provided loan capital for thirty-three energy-efficiency projects. Eight were made to private-sector industrial enterprises, including the brewery, battery manufacturer and electro-ceramics plant, at an average loan size of $687,000. The total average loan amount for all 33 projects was $180,000. Repayments are being made on a timely basis and one loan has already been prepaid. In several cases, a substantial portion of the financing was used to purchase U.S. equipment.

The successful implementation of USAID/Bulgaria's program demonstrates that longer-term project financing is a viable investment option for commercial banks in Bulgaria. Nevertheless, given the relatively complex nature of these projects, UBB is not yet comfortable making loans without USAID's guarantee. The Mission believes that, over time, UBB will develop the capacity to analyze the risk and assess the viability of loans of such investments in-house.

Electrotek, which was succeeded by EnCon Services International on January 1, 2005, prepared and analyzed most borrowers' loan documents for presentation to UBB's credit department. This type of third-party service has growing potential to support financial institutions in tapping sectors where creditworthy borrowers exist. For credit institutions that lack the in-house capacity to analyze new businesses, these service providers can help institutions enter a new market.

In mid-2001 barely 58% of the light fixtures in the town of Veliko Tarnovo functioned. Much of the town's cable network was damaged, causing energy costs and maintenance to soar. During the next year new fixtures were retrofitted and installed, lowering energy consumption from 1,544 kW to 510 kW. By January 2003 the municipality reported savings of nearly 30%. When traffic accidents and crime dropped by 14% from 2001 levels, many municipal officials and citizens concluded that the improved street lighting had positive residual effects, providing not just a comfortable, but also safe environment to the citizens of Veliko Tarnovo.

Increased Attention to the Energy Efficiency Sector— The biggest impact for USAID/Bulgaria was the competition that developed among Bulgaria's private financial institutions. Once UBB began making loans under the guarantee, other banks took notice and made similar loans. The increase in borrower loan requests showed banks the demand and profit potential of municipal and industrial energy-efficiency projects.

Increased Lending by Bank— The partial guarantee was one of the first to be authorized under USAID's pioneering credit authority. By providing UBB with the backing to manage risk, USAID's guarantee aided a sector that financial institutions had previously avoided.

In addition, UBB expanded the terms of its loans from one to two years (considered normal by Bulgarian standards at the time) to more than five years.

Bank Experience Improves Lending Beyond Guarantee— Although the Agency had committed to share the risk equally on all new loans, after the first few years, UBB had the confidence to increase its risk exposure on new loans. The bank's experience prompted it to offer borrowers the same type of energy-efficiency loans and

By providing UBB with the backing to manage risk, USAID's guarantee aided a sector that financial institutions had previously avoided.

increased its credit exposure on loans to first-time borrowers without coverage of USAID's guarantee.

Impact of Technical Assistance and a Guarantee—Technical assistance has been fundamental to the overall success of USAID/Bulgaria's program and UBB's use of the guarantee. USAID guarantees complement the Agency's grant-funded assistance and act as an effective alternative to long-term donor assistance. The combined development assistance complements the Agency's work to reduce negative environmental impacts of old, energy-hungry machinery and support the country's implementation of energy-efficiencies in the public and private sectors.

This example illustrates how banks can be encouraged to finance energy-efficiency projects for municipal operations and private industrial and manufacturing plants. The project is also a good example of how effective technical assistance can be when supplemented by the use of a guarantee. The combined assistance helped UBB identify and attract potential clients, improve client relationships and tailor loan terms to the client's investment needs. By acting as a catalyst for private financing, the guarantee helped reduce unnecessary expenditures on energy, improve municipal finances, and decrease greenhouse gas emissions, while demonstrating the financial viability of long-term lending for energy-efficiency projects.

By encouraging the private sector to provide access to credit, the guarantee fulfills a crucial final step in continuing specific developmentally-beneficial activities by establishing or increasing local financing to provide a sustainable resource.

UBB's continued interest in the energy sector highlights the value of investments benefiting the environment. Their work is being duplicated in other countries where similar municipal infrastructure financing issues exist. USAID/Bulgaria now has six guarantees in place, covering energy efficiency and infrastructure, as well as agriculture and small and medium business development.

LESSONS LEARNED

Over the first twelve months the guarantee was active, the program's success was jeopardized by a conflicting understanding of the goals for its use between UBB and USAID's technical assistance provider, Electrotek. These miscommunications delayed the development of the program and use of the guarantee until UBB and Electrotek worked out a borrower assessment plan. The plan clarified UBB's intended lending strategy, including the geographic areas UBB would be comfortable lending in and the need for any potnetial borrowers to demonstrate an ability to service their debt. Based on a list Electrotek developed of potential borrowers, UBB started lending, developing relationships with municipalities and private enterprise-owners, as well as with city mayors and municipal superintendents.

At the beginning of USAID's relationship with UBB, UBB's privatization (transformation from a state-run into a private bank) caused shifts in staffing and management connected with the bank's use and oversight of the guarantee. The lack of a consistent point of contact at the bank negatively affected the relationship between UBB and USAID. USAID's persistence along with support from EnCon Services helped maintain the lines of communication. ■

DEVELOPING A MORTGAGE MARKET

ROMANIA – LOAN GUARANTEE - 2003

Housing is critical to a country's long-term growth and stability. Beyond giving people shelter and a material stake in their society, housing can be a major engine of growth in an economy. A dynamic housing finance system can provide the necessary boost to a country's financial sector by giving families the potential to buy a home and the ability to use it as collateral to secure credit. This is the market-driven opportunity that USAID saw in Romania's transition economy.

WHY WAS A LOAN GUARANTEE NEEDED?

Access to credit in Romania's real estate sector has been limited by weak financial markets, limited economic growth and restrictive regulations imposed on banks by the National Bank of Romania.

Historically, the country's private banks, like financial institutions in similar economies around the world, viewed mortgage loans as having too many risks— from outstanding credit, to interest rates and too much liquidity on hand. Although financial institutions could offer home mortgages, only a few commercial banks made such loans. Restrictions imposed by the National Bank were compounded by policies that favored commercial banks over other types of financial institutions in taking possession of collateral after default. The few loans that were made were limited to a maximum of ten years and required more collateral than for other loans, as well as a co-signer.

Foreign-owned banks had similar concerns about the ability to take possession of collateral, and instead used their local resources to develop more traditional banking products.

In short, banks that had the capacity and legislative authority to make loans lacked the institutional will. This inflated the risk perceived by lenders in providing mortgage loans and virtually eliminated their expansion into the mortgage market. Consequently, most Romanian citizens had no access to home mortgage loans.

Given these financial and regulatory obstacles, a market-based housing finance system was unlikely to emerge in Romania without comprehensive and coordinated international assistance.

The USAID Mission in Romania, working with other donor organizations, addressed these obstacles through a combined program of policy advocacy, business assistance, credit mobilization and improved mortgage financing practices from Europe and the United States. The program addressed specific legal issues related to Romania's restrictive mortgage law, real estate registrations, as well as foreclosure procedures.

USAID/Romania's immediate objective was to establish a financial company that could provide access to mortgages for Romanians who wanted to buy a home and could generate enough competition to encourage the development of a secondary market. The end goal was to have a secondary market in which the mass of mortgage loans could be collected and securitized for sale on the bond market.

Thinking small would not have accomplished the goal of developing viable primary and secondary mortgage markets in Romania. Attracting private-sector financing through the use of a USAID credit guarantee became a key part of the Mission's strategy.

HOW WAS USAID'S CREDIT GUARANTEE USED?

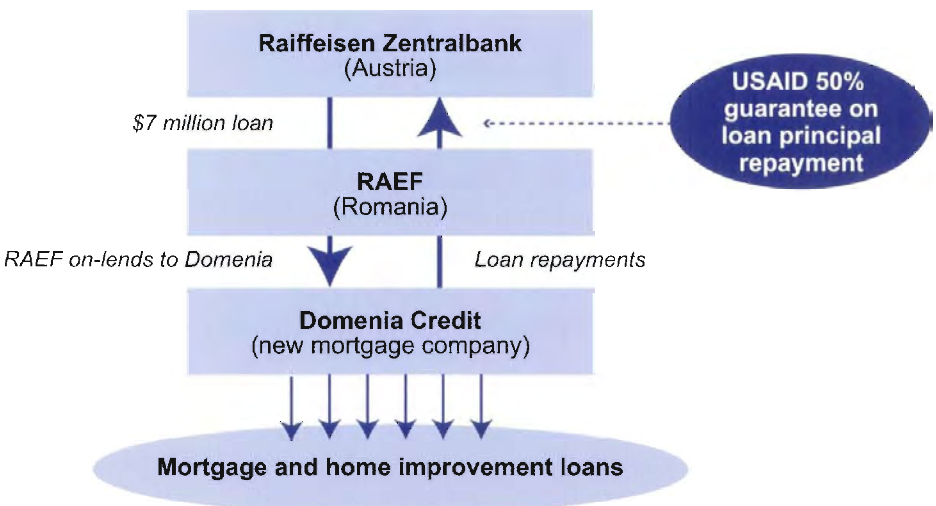
In 2001, USAID/Romania took the first step in developing a national mortgage market by creating the Romanian Mortgage Finance Initiative. Working with a USAID-funded group, the Romanian American Enterprise Fund (RAEF)[1], and another USAID technical assistance provider, Shorebank Advisory Services (SAS), the Mission helped launch a private financial institution that would become the industry catalyst for the country's new mortgage finance system.

Once the mortgage market was established, a secondary market would be developed to mobilize longer-term financial resources, while stimulating local development and the creation of a domestic mortgage market. The RAEF and the Mission worked together to amend Romania's Mortgage Law to allow a newly created financial entity to operate effectively as a mortgage company; and in 2002, Domenia Credit was established.

To initiate operations, Domenia received $3 million in funding from RAEF and a $1.3 million grant directly from USAID/Romania. The SAS provided technical support and covered the initial administrative expenses, while RAEF sought a private source of capital for the new mortgage company. After discussions with several commercial banks, Raiffeisen ZentralBank, a major Austrian bank, expressed interest in providing a loan, with losses on principal covered by USAID's 50 percent loan guarantee.

The presence of USAID's guarantee— designed to be active for twelve years— enabled RAEF to secure a USD$7 million ten-year loan from Raiffeisen. As risk-free collateral for a relatively untested product, the guarantee reduced the potential loss banks associated with lending to a start-up institution, and toany investment in home mortgages or construction financing.

The guarantee encouraged Raiffeisen to make the loan, which provided Domenia with the capital base to begin operations. Once it was legally and operationally feasible, Domenia would take over RAEF's fledgling retail-level mortgage portfolio and develop it into a full-fledged mortgage finance company, able to provide local citizens with a mortgage to buy a home instead of cash.



1 The Romanian Enterprise Fund (RAEF) is a private U.S. corporation whose goal is to promote the development of a mortgage finance system in Romania. Established by the President of the United States and the U.S. Congress in 1994, RAEF was capitalized by a $61 million grant from the United Stated Agency for International Development (USAID).

GUARANTEE TERMS

Housing	Romania - 2003
Type of Guarantee	Loan Guarantee
Guaranteed Party	Raiffeisen Zentralbank Austria
Borrower	RAEF
Maximum Amount of Loan	US$ 7,000,000
Amount fully Guaranteed	US$ 3,500,000 or 50% of loan
Level of Guarantee Coverage	50% of principal
Term of Coverage	up to 12 years
Currency of Loan and Claims	US Dollar

Thirteen months after USAID signed the guarantee agreement with Raiffeisen, Domenia had fully drawn down on the loan and disbursed the funds to mortgage borrowers. A well-trained team of loan officers enabled Domenia to respond aggressively to the market demand for housing loans swiftly and to effectively use the credit it received.

As a result, Domenia was able to establish itself in the housing market while other banks waited, watched and learned from its experiences.

Raiffeisen's guarantee attracted additional financing for Domenia from other private-sector sources by showing confidence in Domenia's ability to repay its loan.

The guarantee enabled USAID to introduce mortgage lending to Romania's financial sector and to develop the country's housing finance system, all without displacing other private lenders. Domenia's presence encouraged other financial institutions, besides the commercial banks, to enter the mortgage marke as they came to recognize the profitability in mortgage lending.

Within a short period of time, the new company was attracting significant interest and then competition. As a result, longer-term loans—up to 25 years from the usual 10 years—started being offered. Credit became more affordable for borrowers, which in turn drew more of them into the market, prompting ever-increasing competition among the banks. The interest other banks had in joining the mortgage-lending market would prove crucial in developing Romania's secondary market.

Government reform followed. In 2003, the Ministry of Finance, assisted by the USAID Financial Market Reform Project, established a Mortgage Task Force to further initial reforms and initiatives to develop a secondary mortgage market in Romania.

The legal and regulatory changes that helped create Domenia and the procedures for extending mortgage loans became the foundation for a larger national effort.

In collaboration with Deloitte Touche Tohmatsu (the implementing contractor for the Financial Market Reform Project), SAS and RAEF, the Mission assisted the government, donors and financial institutions to rapidly expand the mortgage market. The improvement in Romania's economy after 2000 and the adoption of a number of economic reforms led to a sharp increase in demand for mortgages.

Beyond the swift development of Romania's mortgage market, there were other longer-term benefits. Efforts were also undertaken to boost the level of services for Romanians interested in purchasing new homes.

Domenia's credit committee reviews the loan application of a new borrower.

As the possibility of receiving a mortgage brought homebuyers into the market, activity in the construction and home building industries picked up. With more affordable housing available, sales increased, new jobs were created and new investment opportunities appeared, bolstering ancillary markets and further benefiting the country's prospects for economic growth.

WHAT WAS THE IMPACT OF USAID'S GUARANTEE?

The use of a credit guarantee was a critical component of USAID's strategy to develop a national mortgage market and serves as an example of how access to credit can be successfully woven into broader USAID initiatives. From a micro to a macro level, the development of Romania's mortgages financing system had several significant results.


Mr. Kuchta's work (inset) is accepted as collateral by Domenia Credit for a loan to build a new home. Both the type of loan and the collateral accepted are firsts for Romania.

Longer-Term Lending— USAID's guarantee was pivotal in mobilizing long-term capital, a key driver of the program's success, which was not otherwise available for residential mortgages. This long-term source of private capital matched the longer repayment periods of residential mortgages offered by Domenia and leveraged additional resources for USAID's mortgage program.

Creating a New Type of Financial Institution— The guarantee was the appropriate tool to support financing for a brand new financial institution. Unlike a grant, the guarantee helped Domenia establish a financial relationship with a commercial bank, Raiffeisen. Over time, the continuing success of that relationship has cemented Domenia's access to credit from the private sector, and provided the perfect catalyst for the new company's growth.

Increasing Home-Ownership— By providing financing for residential mortgages, more Romanians were able to purchase their own home. In addition, when approaching Domenia for a mortgage, home buyers also had access to additional services offered by the company, including insurance, inspections and appraisals. This 'one-stop-shop' introduced a brand new concept to Romanians that has since been replicated across the country.

Fostering Competition Among Lenders— USAID's guarantee supported the development and broadening of a modern capital market in Romania by laying the groundwork for longer-term financing instruments, innovative financing models and sale of securitized financial instruments as negotiable securities, none of which had previously existed in the country.

Following Domenia's first few mortgage loans and the demand that ensued, competition not only developed, but thrived. The creation of a secondary mortgage market, in turn, will further deepen Romania's capital markets by offering investors new financial products, bringing additional liquidity to the market.

For one Romanian citizen, Armand Kuchta, Domenia's impact was more personal and a bit of a novelty. "I recently contacted Domenia Credit for a US $26,500 construction loan needed to finish my beloved home [in] Neamt. Unlike other lenders, Domenia Credit considered my incomes from painting and restoring monasteries and buildings eligible [see photo insert at left] and I successfully qualified for a mortgage loan. Domenia's people proved themselves to be very efficient, quick, and flexible in analyzing and approving my loan application." Mr. Kuchta's house is nearly finished. ■

FINANCING MUNICIPAL INFRASTRUCTURE PROJECTS

SOUTH AFRICA – PORTABLE GUARANTEE - 1999

In 1994, the reign of apartheid in South Africa came to an end, and the country began to emerge as a new democracy. The country's new-found potential for growth and opportunity brought many new and challenging realities. Among them were disparities in basic urban services provided to local communities once hidden behind apartheid's veil. With the end of its reign, these disparities were exposed. Many South Africans lacked access to the infrastructure that, for example, provided electricity, clean water and sanitation. By World Bank estimates roughly 40 percent of South Africa's population did not have running water or electricity in the early 1990's. Although infrastructure is crucial to developing underserved areas and to reducing poverty, numerous municipalities could not obtain the long-term financing needed to initiate such projects.

During apartheid, racial divisions were reflected in the imbalance of services available to poorer sections of South Africa's cities. Infrastructure services in white municipalities were well developed. These urban areas benefited from a variety of financial resources, including the collection of fees and taxes for service. The municipalities had long-standing relationships with local commercial banks and access to long-term credit from the private capital markets, supported by guarantees from the central government. In addition, the central government required South African banks to maintain a portion of their assets as municipal securities. This financing requirement was risky for the financial institutions whose investment portfolios were over-weighted in municipal debt, but it benefited the municipalities that used the capital to upgrade services and implement new projects.

WHY WAS A LOAN GUARANTEE NEEDED?

Similar financing did not exist for black townships in South Africa. Instead, the government's municipal investment requirement for banks distorted the market and subsidized services to wealthy communities. Meanwhile, the townships, which lacked similar support, lost opportunities to access such financing and to learn the lessons of municipal governance that would help them develop basic infrastructure services to address the needs of South Africa's urban poor.

In the mid 1990's, as part of the new majority government's work to break down such apartheid-era norms, racially-separated jurisdictions were incorporated into one large municipality. In Johannesburg, the country's largest city, this incorporation of previously autonomous areas meant that underserved townships and the city's wealthy business and residential districts, which had operated as distinct governing bodies, were now re-grouped to form one large, and very diverse, municipal system.

Despite Johannesburg's position as the financial and commercial hub of the country, roughly three-quarters of the people lived in large townships and shantytowns. These areas were grossly under-served, lacking clean water, electricity, sanitation and other basic services. Within the city's boundaries, for example, 21 percent of housing was graded inadequate.

As the previously 'off-grid' townships and the highly self-sufficient communities were incorporated into the newly renamed Greater Johannesburg, the city expanded in size, population and priority infrastructure projects. Integrating South Africa's disenfranchised citizens, particularly its unemployed youth, was critical to sustaining as well as expanding the city's productivity. With 40 percent of Johannesburg's population under the age of 24, the youth represented a significant workforce resource needed to support the country's economic growth.

With South Africa's cities contribute approximately 80 percent of the nation's gross domestic production and Johannesburg alone accounting for 16-20 percent. Reducing urban social inequities and unemployment was a high priority for the new majority government.

The Greater Johannesburg Municipal Council (GJMC), the city's newly created local governing body, was responsible for addressing the imbalance in services and financing the construction of priority infrastructure projects in under-developed areas.

Five years earlier, GJMC was able to access credit from private commercial sources to finance its operations. However, the substantial capital-outlay and longer-term requirements necessary for the newly-planned, large-scale infrastructure projects virtually eliminated GJMC's ability to borrow capital. The city's historically low level of collections of fees and taxes and the commercial bank's lack of interest in lending to municipalities made GJMC a high risk borrower. As a result, it was considered un-creditworthy and unable to raise the needed funds to implement critical infrastructure upgrades.

One of USAID's major goals in South Africa was to support the development of and access to environmentally-sound, urban services. Work was focused on communities where inadequate infrastructure hindered growth and promoted poverty, albeit unintentionally. The underlying objective was to increase the quality and quantity of water and sanitation services for the poor by supporting investment in and improving management and delivery of those services to areas where they were absent or remained under-developed.

USAID's Mission in South Africa supported the turnaround of the newly integrated city by providing grant-funded technical assistance. This was part of a broad effort to assist South African municipalities in providing public services to all areas and citizens equally, and to help them become self-sufficient, financially sustainable entities. With USAID's backing, GJMC (the 'city') re-organized

This was part of a broad effort to assist South African municipalities in providing municipal services to all areas and citizens equally, and to become self-sufficient, financially sustainable entities.

its operations to improve service delivery and management of the new facility. USAID's support included training for key GJMC officials on budgeting, financial management, debt restructuring, property tax collection, and collection of water and electrical user fees (municipal revenue collection), as well as a rehabilitation program for the city's credit rating. The city planned to divide its municipal services (water, electricity and sanitation) into three separate utilities to operate privately and for profit.

Although early service improvements benefited parts of Greater Johannesburg, the revitalization did not increase GJMC's access to long-term private commercial financing for the city's planned utilities. The GJMC's credit rating first needed to be upgraded.

USAID's partial guarantee was intended to complement the Agency's grant-funded technical support by lowering the credit risk to a private commercial bank for a long-term loan to GJMC that would finance new water, sanitation and electricity projects.

HOW WAS USAID'S CREDIT GUARANTEE USED?

In 1999, USAID/South Africa proposed that GJMC consider the use of a portable guarantee to help it access financing to initiate work on high-priority infrastructure projects. The presence of USAID's 10-year guarantee helped upgrade GJMC's credit rating and rendered it eligible to secure the necessary financing. With the guarantee, GJMC approached local private financial institutions to obtain a 10-year loan for 150 million South African Rand (the equivalent of US$25 million) at an affordable rate.

established with a borrower, it becomes a loan guarantee for the lender once the lender is identified and has signed a guarantee agreement with USAID. In this example, GJMC could present the commitment letter to financial institutions as proof of USAID's commitment to provide the guarantee. The risk-sharing arrangement would reduce the lender's potential for loss while strengthening GJMC's capacity to deliver crucially-needed clean water and sanitation services. In addition, it would expose other lenders to the benefits of financing longer-term infrastructure projects.

As part of its efforts to establish a sustainable link to private-sector capital, GJMC was asked to prepare a Project Delivery Plan. The Plan would act as the basis for GJMC's

The risk-sharing arrangement would reduce the lender's potential for loss on the loan while strengthening GJMC's capacity to deliver crucially-needed clean water and sanitation services.

GUARANTEE TERMS

Water and Sanitation	South Africa - 1999
Type of Guarantee	Portable Guarantee
Guaranteed Party	ABSA Bank
Borrower	Greater Johannesburg Municipal Council (GJMC)
Maximum Amount of Loans	US $25 million
Amount of Guarantee Ceiling	US $12.5 million or 50% of max. loan amount
Level of Guarantee Coverage	50% of principal
Term of Coverage	10 years
Currency of Loans	South African Rand

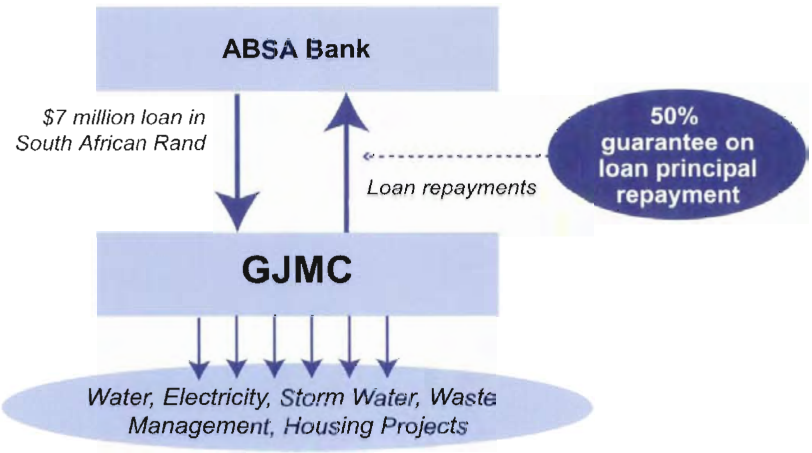
The portable guarantee provided GJMC with a commitment letter pledging USAID to cover 50 percent of principal on a loan to GJMC from a local financial institution. Although a portable guarantee is initially

loan application, accompanied by USAID's commitment letter. The Plan established the eligibility criteria for all projects to be covered by the guarantee and outlined GJMC's project prioritization for review and

approval by USAID. Additionally, the Plan outlined the city's broader capital investment strategy, the utilities' re-organization plan, and the anticipated revenues that would be used to service GJMC's debt. While USAID had no direct role in the selection of particular infrastructure projects, it did analyze each project's financial viability.

To qualify as a lender under the guarantee, financial institutions needed to have a Fitch-IBCA credit rating (or its equivalent) of "A" or better. In addition, the lender would be charged a loan guarantee origination fee and an annual transaction or 'utilization' fee for loans under coverage. All loan disbursements would be tied to the progress of construction, as certified by GJMC.

To find a lender, USAID worked with GJMC's financial advisors, Specialized Outsourcing, and put together an "auction" document to announce GJMC's loan request to the financial markets and solicit responses from local financial institutions. Specialized Outsourcing ran the process and received 13 bids. Of those bids, ABSA Bank offered the best loan terms for GJMC and was offered the guarantee by USAID to cover its loan.



WHAT WAS THE IMPACT OF USAID'S GUARANTEE?

New Services Delivered– GJMC was able to use the proceeds of ABSA's loan to finance the multi-year costs of several high-priority infrastructure projects for urban services, such as clean water and solid-waste disposal that would improve the quality of life for local inhabitants. In addition to technical assistance already operating, USAID/South Africa's use of a partial guarantee strengthened Johannesburg's delivery of services for the already large and growing population.

Access to Capital Markets– USAID's technical support and partial guarantee helped the city improve its credit rating and access long-term private financing for municipal infrastructure.

By further developing and demonstrating adequate planning and budgeting to the local commercial banks as well as establishing a history of repayment, GJMC strengthened its access to private financing for future projects.

Following significant improvements in the collection and accounting of service taxes and a balanced budget, the city's credit rating was further upgraded. Consequently, GJMC was able to go to the capital markets on its own and obtain a new loan.

Access to Municipal Finance– Without USAID/South Africa's support and the competitive environment created by the guarantee, GJMC would not have received the loan from ABSA Bank. USAID's guarantee helped GJMC demonstrate its creditworthiness to other potential lenders. In June 2004, halfway through their loan repayment to ABSA, GJMC obtained financing at a better rate from the capital markets and pre-paid its existing debt to ABSA Bank. As a result, GJMC was able to reduce interest payments by approximately R1 million over its existing loans, a significant cost savings that could translate into additional capital available for other infrastructure projects.

Model for Other Municipalities– With the success of USAID's guarantee, GJMC's actions became a model for other municipalities, demonstrating the steps necessary to become a creditworthy borrower for those seeking similar financing from the capital markets. USAID/South Africa now has six guarantees in place covering infrastructure, as well as housing, banking microfinance and water-related activities. ■

MFI ACCESSES CREDIT FROM CAPITAL MARKETS

PERU – BOND GUARANTEE - 2002

Microfinance is a crucial resource for people in developing economies. As a part of the banking system, microcredit is targeted to the very poor, providing micro and small loans to individual borrowers for personal, entrepreneurial and established small business activities where few alternative credit options exist. These loans are crucial to borrowers and have can significant residual benefits on their families and local communities.

In Peru, as in many other countries, microcredit lenders help microenterprise owners establish and expand their operations by offering the types of products and services needed by the poorest members of society. The growing demand for such financial services is pushing microfinance institutions (MFIs) to look for capital from outside sources to cover gaps in their capital base.

Traditionally, when in-house funds are not enough to cover expanding loan activity, many microcredit lenders rely on grants from donors and loans from the public sector to cover the gaps in liquidity. A major challenge for the continued growth of the microfinance sector, and for microcredit lenders, is to attract external sources of private capital.

In Peru, the economic and political environments were both a help and a hindrance to the development of the microfinance sector. In 1997, the President of Peru declared his commitment to the development of the sector. To support the conversion of Peru's non-government organizations (NGOs) into formal microfinance institutions, the Government of Peru provided access to lines of credit through COFIDE, a public wholesale bank, to expand their loan portfolios. NGOs that intended to become formal microcredit banks were all given grants to perform feasibility studies that they were required to submit when requesting a banking license.

While the President of Peru was strongly committed to strengthening microfinance institutions, government loans skewed the market and virtually eliminated commercial interest and investment in them. Mibanco, for example, one of Peru's leading microfinance institutions, had funding from public investments, donor grants, and credit lines with large commercial banks mainly secured through donor letters of credit. Mibanco wanted to develop a sustainable, long-term source of funds and approached USAID for support in gaining access to private financing.

WHY WAS A LOAN GUARANTEE NEEDED?

The USAID Mission in Peru has actively supported countrywide initiatives encouraging the private sector to make credit available to MFIs. In its work, USAID had already developed a good working relationship with Mibanco, supporting its efforts to become a formal and fully-licensed microfinance bank. Mibanco's interest in expanding its microcredit activities made it an ideal partner to develop a method to access capital from the private sector.

Established in 1998, Mibanco was designed to provide financial services to Peru's poorest citizens. Clients were typically small-scale, informal vendors from poor districts in and around Lima. By 2000, Mibanco had become a fully-licensed bank and could take deposits from the public through products such as savings accounts, time deposits, and severance payments to individual accounts. Microentrepreneurs accounted for 92 percent of the bank's loans. The remaining eight percent were split between commercial and consumer loans. Loans averaged $450, and urban micro-lending accounted for a majority of Mibanco's business. During the two-year period, Mibanco grew to include 24 branches, located predominantly in the metropolitan area of Lima and Callao, and had a staff of 435. More than 60 percent of the bank's 60,000 clients were repeat customers.

HOW WAS USAID'S CREDIT GUARANTEE USED?

As one of a number of ongoing projects to reduce poverty in rural and urban areas around Lima, USAID worked with Mibanco to structure a portable guarantee that would help it access credit to continue its growth, albeit at a more moderated pace. The portable guarantee is represented by a commitment letter from USAID to Mibanco committing USAID to guarantee any private lender for up to 50 percent of principal on a loan to the bank. The guarantee was intended to lower a lender's risk, and as a result, help Mibanco find a private source of credit willing to provide the loan.

It did not work. For nine months Mibanco approached various financial institutions but was consistently denied. At the time, banks in Peru were not willing to take on the risk of lending to a microfinance institution, especially ones that, as a result of that loan, could later become a competitor.

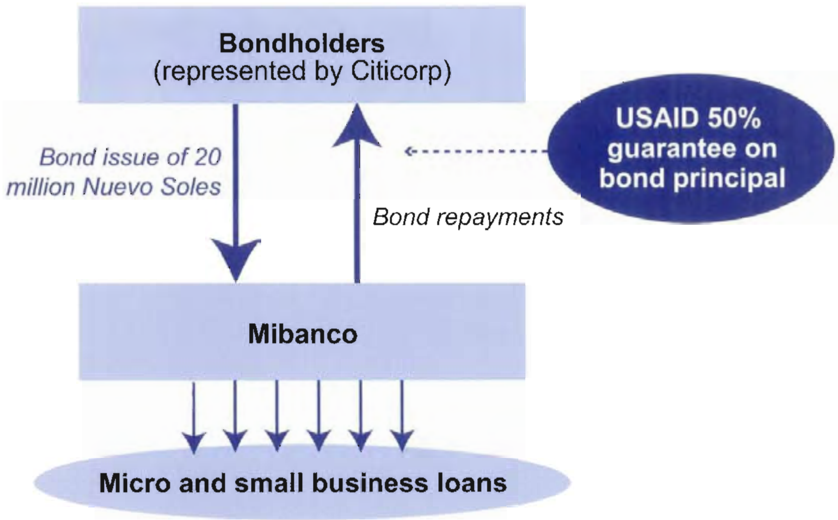
In a conversation with USAID about the difficulty in accessing credit, even with the portable guarantee, the suggestion was made for Mibanco to, instead, issue a corporate bond. Due to the private financial institutions' aversion to risk, the bond issuance was considered a good alternative, enabling Mibanco to access private capital with the least individual risk to its investors, and establishing Mibanco's presence in Peru's private capital and financial markets.

USAID's bond guarantee could also help Mibanco reach investors with greater risk tolerance and a willingness to accept longer repayment terms than those available to them at the time. With help from USAID/Washington and a bit of additional time, the original portable guarantee was deconstructed, and the bond guarantee designed and approved to replace it.

In February 2002, Mibanco and Citibank Corporate Finance & Capital Markets Peru (referred to as Citibank Peru, a branch office of Citigroup USA) signed an agreement for Citibank to act as placement agent for the bonds' sale, otherwise known as the "bond issuance". As the placement agent, Citibank would advise Mibanco on the sale of its bonds, prepare Mibanco's registry, verify the accuracy and integrity of the information submitted for the issue and handle the sale of the bonds. Citibank was also relied on to review and monitor Mibanco's operations prior to the bond issuance. (On the Lima Stock Exchange, to sell bonds, the issuer must request to be registered in the Registro

GUARANTEE TERMS

Microfinance	Peru - 2002
Type of Guarantee	Bond Guarantee
Guaranteed Party	Bondholders
Borrower	Banco de la Micro Empresa S. A. (Mibanco)
Maximum Amount of Portfolio	US $6 million
Amount fully Guaranteed	US $3 million or 50% of portfolio
Level of Guarantee Coverage	50% of principal
Term of Coverage	5 years
Currency of Loans	Peruvian Nuevos Soles



Público del Mercado de Valores and provide information on the company and on the securities, in this case, the bonds being issued.) Partnering with a reputable commercial bank like Citibank limited the risk inherent in the transaction for potential investors.

Mibanco also contracted Citibank Peru to act as the trustee. In the event of default, Citibank Peru was obliged to pursue collections on behalf of the bondholders and USAID. While some concern was raised about the potential conflict of interest in Citibank playing the role of both placement agent and trustee, USAID was assured that the departments would operate independently. It was considered standard industry practice. Additionally, bondholders would be free to replace the trustee, if there were any question of Citibank's ability to manage its responsibilities and perform as expected.

As a microfinance institution, Mibanco's bond issuance would be a first for Peru's capital markets. The bonds were structured as two-year corporate bonds for sale to institutional investors at the price of the Peruvian Nuevo Sol equivalent of US$6 million. Institutional investors, such as insurance companies, pension funds, and mutual funds have large amounts to invest and are assumed to be sophisticated investors, able to protect themselves from the higher levels of risk inherent in these types of transactions.

In the Peruvian capital markets, pension funds are the most important institutional investors. Public and private pension funds account for a majority of Peru's capital market transactions and were the target group for Mibanco's sale.

One significant challenge to the sale of Mibanco's bonds was the Superintendent of Banks' regulation restricting pension funds from purchasing bonds with low investment-grade credit ratings. As Mibanco had never issued a bond and lacked a credit rating and the track record to prove past repayment performance to investors, USAID's guarantee was key to Mibanco's proving itself a creditworthy institution, worthy of a good credit rating for the sale. The guarantee would provide a crucial layer of security for investors which Mibanco hoped would increase its credit rating to a satisfactory level for the bonds to be available to institutional investors.

For investors to determine the likelihood of default in purchasing an asset (like a bond), a standard international credit rating system is used to designate the range and levels of risk. The range is listed alphabetically, from AAA, least likely to default (considered the best), to AA, and A, then to BBB, BB and so on, down to the worst, D (for entities already in default).

The presence of the guarantee ensured that USAID would cover half of the principal amount of the bonds in the event Mibanco was unable to meet its debt obligation to the bondholders. If all the bonds were sold, USAID's total liability would be $3,000,000.

Without the guarantee, the novelty of the transaction and Mibanco's unknown financial history could result in a very low credit rating that would, by law, eliminate potential bids from Peru's pension plans.

For Mibanco to determine the lowest return it could offer investors and still generate enough interest to sell the entire offering, the bond was subject to a Dutch auction, a common practice in the Lima Stock Exchange. In a Dutch auction, the details of a bond issuance, such as the suggested price per bond and quantity of bonds to be issued, are made public. The offer remains open for a limited period of time during which the price is gradually lowered until a bid is received. This bid becomes the price at which the bond is sold.

WHAT WAS THE IMPACT OF USAID'S GUARANTEE?

A few days before the bonds were issued, Mibanco received its credit rating, "AA", a very high mark for the previously unrated financial institution that made the bonds accessible to pension funds. Due to the high credit rating, by the time the bonds were issued, demand already exceeded the number of bonds available.

The sale was a complete success. The bond offering created a new source of capital for Mibanco, generating the capital it needed, and allowing it to establish a credit rating and a reputation as a creditworthy institution. With the longer repayment terms, Mibanco could extend the loan terms it offered its own clients, creating a ripple effect of benefits along the microfinance value chain.

Peruvian pension funds purchased 87 percent of the bond issue. Mutual funds bought the remaining 13 percent.

Access to Capital Markets and Private-Sector Credit– USAID's bond guarantee gave Mibanco access to Peru's private capital markets. Deposits and the capital generated by the sale of the bonds helped Mibanco avoid over-reliance on financing from the public sector and thus encouraged the development of more sustainable financial resources for itself and other similiar microcreditinstitutions.

Since the sale of its first bond in 2002, by performing well and remaining financially solvent, Mibanco has issued and sold several more bonds to further expand its savings and capital base. Each bond was priced at a significantly reduced nominal rate from the first bond and without additional collateral required.

By continuing its use of bonds to generate capital, Mibanco has solidified its place in the capital markets and, as a result, no longer needs a guarantee to ensure repayment to its investors (Mibanco issued a second bond with a guarantee from the Andean Development Corporation, but its third bond issue had no credit enhancement). The first bond was later traded on the secondary market and at the two year mark, was repaid in full, validating Mibanco creditworthiness to Peru's financial markets. Mibanco continues to raise capital without further need for a guarantee or other type of credit enhancement.

Each bond was priced at par, without additional collateral and at a significantly reduced nominal rate from the first bond.

Increased Recognition of Microfinance Sector– To draw interest from investors, USAID's guarantee helped demonstrate the viability of local capital-market funding for MFIs and initiated a process that has substantially altered the level of recognition microfinance institutions and microcredit lending have in Peru's banking sector and financial markets. Mibanco's work and partnership with USAID have benefitted both the microfinance sector as a whole, and Peru's numerous microfinance institutions.

MFIs such as Cajas Municipales de Ahorro y Credito and the EDPYMEs followed Mibanco's lead to access the capital markets by lobbying Peru's Congress and the Superintendent of Banks to approve a modification of the country's banking law. The modification would facilitate the process and requirements for non-bank financial intermediaries, especially MFIs, to issue bonds.

As a result of the MFIs and their supporters' efforts, the modification was approved and the banking law changed to make the process of obtaining credit easier for Peru's MFIs. Following Mibanco and Cajas Municipales' success, a number of MFIs are now preparing bond issuance strategies. USAID is considering establishing additional partial guarantees (to one or more of these institutions) to further increase MFIs potential to benefit from additional and more sustainable credit resources for their on-going lending programs.

Model for Microfinance Institutions Seeking Private Sources of Credit– USAID's guarantee helped launch an innovative financing transaction that has created a new credit resource for MFIs in Peru. The issuance of a microfinance bond has made a large and important impact in the continued development, and deepening of the country's bond market. It has created investment opportunities on the buy and sell sides, both for the microfinance institutions and for private-sector investors. By reducing the perception of risk for private institutional investors, the guarantee has encouraged the flow of Peruvian domestic capital into local development, and in particular, into microfinance activities. It also demonstrates the potential for private capital markets to finance individual microfinance institutions.

LESSONS LEARNED

The ability to access expertise from USAID with regard to the design of the guarantee's structure was a significant benefit. In addition, neither USAID's team in Peru nor Mibanco fully understood what the challenges of issuing a bond would be. The availability of capital markets expertise from USAID/Washington helped smooth the process and supported the successful development of the project from the initial concept and redesign of the guarantee structure, to the drafting of the bond guarantee agreement, and the successful sale of Mibanco's first bond.

USAID/Peru now has seven guarantees in place: three guarantees support the development of financial services to microenterprises, another three promote alternative development activities by agribusinesses and a final one which supports cleaner production by Peruvian businesses to benefit the environment. ■

A farmer in Peru represents one of type of microfinance client that could benefit from private loans to microfinance providers. Photo: USAID/Chris Ray

NEW CREDIT OPTIONS FOR SMALL BUSINESSES

VIETNAM – LOAN PORTFOLIO GUARANTEE - 2003

Despite good overall economic performance, Vietnam has lagged behind in some areas of state enterprise and financial sector reform. The Government of Vietnam has increasingly recognized the important role of the private sector in contributing to economic stability, reducing poverty, and promoting transfers of skill, technology, and capital. However, state enterprises still benefit from the easy availability of credit from state-owned banks. Private firms cannot access loan funding on comparable terms and are often hostage to excessive collateral requirements which do not take into account their commercial performance or future earnings or cash flow. This handicaps the robust development in Vietnam's private sector. Developing domestic businesses, therefore, is crucial to Vietnam's economic growth and development strategy. Despite many encouraging recent achievements, the restraints facing small and medium-sized enterprises (SMEs) restrict Vietnam's transition to a more open, market-based economy able to compete internationally.

Calls for financial reform to develop the country's capital markets led the Government of Vietnam (GOV) to implement a number of new laws, including the Law on State Banks, the Law on Credit Institutions, and the Foreign Bank Decree. The passage of the Enterprise Law in early 2000 spurred dramatic growth in the private sector and has been one of the most striking features of Vietnam's economy over the past few years. The Enterprise Law formalized the small business sector by requiring enterprises to register with the government; but in so doing, also recognizes people's right to engage in private enterprise in a communist state. Over the first three years, the total number of businesses increased from 15,000 up to over 100,000.

The reforms were widely seen as successful, generating impressive growth in the number of new businesses established or formalized following the adoption of the new Enterprise Law. However, the private sector in Vietnam remains underdeveloped. Significant obstacles still exist in creating a supportive environment for private-enterprise growth. These weaknesses are often the result of barriers in the market, including unfair competition from state-owned enterprises, as well as an underdeveloped regulatory environment. Internally, the private sector still faces an unequal playing field, including discrimination from several administrative authorities—such as the state-owned commercial banks—over access to land and to credit, lack of transparency; an inefficient taxation structure that favors state-owned enterprises; a weak legal framework with inconsistent, arbitrary regulations; and inconsistent political will to undertake large-scale market transition reforms.

One of the most fundamental challenges to private-sector growth in Vietnam, however, is the lack of access to credit, especially for the large and continuously expanding number of small and medium-sized businesses. Vietnam's four state-owned commercial banks (SOCBs) have traditionally overlooked these businesses, lending mostly to large state-owned enterprises. The SOCBs control over 70 percent of commercial lending in Vietnam. Consequently, one of the few formal sources of capital that SMEs have had to rely on is the private commercial joint-stock banks (JSBs). The JSBs, though, made up only 12 percent of Vietnam's lending market—mostly from small local banks' loans. The SMEs comprise 90 percent of Vietnam's private-sector businesses.

In numerous surveys conducted by the World Bank, the International Finance Corporation (the private-sector development arm of the World Bank) and other donors, SMEs consistently cited their lack of access to credit as a primary barrier to growth. As a result, over time, the private banks, and in particular, the JSBs, have limited smaller businesses' access to credit by following a government policy that requires borrowers to pledge substantial collateral to obtain a loan. In addition, inadequate disclosure requirements and tax incentives that promote inaccurate financial accounting have supported the high collateral requirements SMEs must meet to obtain commercial credit. Since JSBs lack sufficient information to perform cash flow-based credit analyses and the management capabilities to meet basic credit requirements, many bankable projects go unfunded.

WHY WAS A LOAN GUARANTEE NEEDED?

The USAID Vietnam Office of the Regional Development Mission/Asia (USAID/Vietnam) is focused on assisting the GOV's efforts to implement trade and investment reforms outlined in the U.S.-Vietnam Bilateral Trade Agreement. Additionally, USAID is working to address the key obstacles of Vietnam's emerging private sector. The results of its 2002 private sector assessment prompted USAID/Vietnam to develop the Vietnam Competitiveness Initiative (VNCI) to focus on several of the obstacles cited. The Initiative encompassed a three-year plan that would create an enabling regulatory framework for private-sector businesses; improve access to information, training, technology and business development services; and improve SME ac-

A flower shop in a local market is just one type of small business that can benefit from access to credit. Photo: USAID/Chris Ray cess to credit, mostly from local joint stock banks.

USAID/Vietnam chose to use a partial credit guarantee to address some of these market imperfections and to follow on the work done under the Vietnam Competitiveness Initiative. The guarantee was structured to cover up to $5 million in new loans from a private commercial financial institution, to small and medium-sized businesses. It was intended to increase the financial institution's capacity to assess credit quality, in particular, on a non-collateral basis. By developing the bank's lending capacity, the project would expand access to private-sector loans for financially viable SME activities. In addition, the project could act as a model for the local banking community in lending to this growing sector and motivate other JSBs (and potentially the SOCBs) to develop similar skills and compete for Vietnam's virtually untapped and fast growing debt market for SMEs. Such changes in the financial environment will have profound implications for the country and its potential to move toward a more business and service–oriented economy, able to compete in international markets.

In recent years, several leading private banks are beginning to adjust their eligibility requirements for SME borrowers to make the bank's more flexible by increasing their lending decisions on borrowers' cash-flow information. At the same time, the top-tier JSBs have made a significant effort to expand their operations and to develop a national presence to compete with the SOCBs.

Despite new Vietnamese private enterprises being established at a rate of 1,600 per month, genuine growth in the private business sector has lagged behind the formal policy reforms of recent years. While many obstacles and biases remain, Vietnam has entered a period of rapid growth led by the private sector and it is the private sector that is becoming an increasingly important source of investment and revenue for the national budget. The private sector is the single most important driver of job creation in Vietnam and will be for the foreseeable future. Its capacity to generate new jobs is crucial to most of the 1.4 -1.5 million workers who enter the labor force every year. The Government of Vietnam and, in particular, the Ministry of Finance and the State Bank of Vietnam consider USAID's partial guarantee an essential complement to its new legal and financial reforms agenda.

HOW WAS USAID'S CREDIT GUARANTEE USED?

The borrowers targeted by this program are Vietnamese SMEs with capital of 10 billion or less Vietnamese Dong (VND) (approximately US$633,000) and/or up to 500 employees (about 90 percent of Vietnam's businesses). These businesses include light manufacturing, tourism, agribusiness, export, construction and other operations established under Vietnamese law. The sectors were chosen for their growth potential and, in the long term, for their ability to raise Vietnam's competitiveness to the international market level. Borrowers' access to financing was intended to strengthen these businesses and expand their operations to help Vietnam enter broader markets and international trade.

GUARANTEE TERMS

Small & Medium Enterprises	**Vietnam – 2003**
Type of Guarantee	Loan Portfolio Guarantee
Guaranteed Party	Asia Commercial Bank
Borrowers	Small & Medium-size Enterprises
Maximum Amount of Portfolio	US $5 million
Amount of Guarantee Ceiling	US $2.5 million or 50% of portfolio
Level of Guarantee Coverage	50% of principal
Term of Coverage	5 years
Currency of Loans	Vietnamese Dong

As the most well-known and highly regarded joint-stock bank, the Asia Commercial Bank (ACB) is pioneering the modernization of Vietnam's banking sector and its integration into international trade markets. Asia Commercial Bank is the largest joint-stock bank in Vietnam– with an extensive network of 40 branches across the country. It leads its peer group in total assets and equity. As of the be-ginning of 2005, the bank had increased its registered capital to VND 600 billion (about $40 million) from last year's record of VND481 billion (approximately $32 million). The growth reflects an important increase in the sustainable and long-term development of the bank.

Asia Commercial Bank's aggressive growth strategy has focused on competing with the four state-owned banks that have long dominated the country's banking sector. Central to this strategy is the adoption of new banking technology. The ACB has been a leader among the JSBs in the use of debit cards, development of new credit-risk scoring technology for consumer finance, and installation of an information technology system that conforms to international banking standards. In addition, ACB is making a great effort to expand its network of branches and transaction offices, attract highly skilled employees, invest in product development and build a core group of administrative staff and professional managers.

The ACB is taking advantage of USAID's guarantee to support SMEs, the most dynamic segment in its loan portfolio, as it gradually moves away from heavily-collateralized loans to sound and sustainable cash flow-based lending practices. The bank's actions could be a model for other banks as they attempt to ease the requirements for secured loans to SMEs. This last point, among a list of considerations, was the reason USAID chose to offer the guarantee to ACB.

The unstable economic situation in Vietnam has made it hard for banks to shift from long-term collateral-based to cash flow-based lending. While most JSBs only accept real estate as collateral for loans, ACB was willing to accept assets like working capital inventories and equipment. Vietnamese citizens do not own their own land, and therefore can only provide the value of their land use rights as collateral. In addition, ACB wanted to take on riskier clients, such as those who do not have the required level of collateral.

While ACB is diversifying and developing capabilities in areas from securities trading to individual lending, the growth in its SME loan portfolio is a priority. With individual loans comprising 60 percent of the bank's overall loan portfolio, USAID's guarantee fits well with the bank's strategy to increase lending to small and medium businesses. It also works with the bank's interest in building its capacity to perform cash flow-based analyses, as well as its strategy to become a serious participant in the development of the SME market.

Asia Commercial Bank is taking advantage of USAID's guarantee to support SMEs, the most dynamic segment in its loan portfolio...

USAID/Vietnam is at the beginning of a long-term initiative to help financial institutions make the shift, encouraging banks to look not only at the amount of collateral available but also at a borrower's financial history and the cash flows of their business. The ACB is the test pilot that other financial institutions are watching to gauge the level of risk or profit from its new lending activity. The Mission believes ACB's actions will give banks a sense of the potential value of this untapped credit market and motivate them to become active participants.

Short-term lending (less than one year) dominates loan portfolios to SMEs in most, if not all, joint-stock banks in Vietnam. The ACB's commitment to the development and sustainability of its new lending program focused on medium-term lending to SMEs. In order to receive the greatest value out of the guarantee, ACB carefully incorporated the new lending activities it had agreed to with USAID into its operations and disseminated information about the resulting strategy through-out headquarters and to all its branches. The bank also received on-the-ground technical guidance and monitoring assistance from USAID/ Vietnam.

To ensure the overall success of the new guarantee, ACB provided a contact person to smooth the communication between the bank and USAID. The bank also set up performance goals to track the number of disbursements and the impact of each loan. All of the branch credit officers received training on ACB's new lending strategy and the presence of USAID's guarantee as part of a 'Train the Trainers' course. The newly trained team leaders then visited each of the branches to instruct loan officers on the new products and internal procedures, and provided a package of materials that were developed for the training. The marketing plan was developed and executed using posters, booklets and brochures to promote the banks' new lending to small and medium-sized businesses. The ACB also announced its new lending program in the local newspapers and hung banners at the bank's headquarters. An additional brochure was created to advertise the program in preparation for the bank's nationwide marketing campaign.

LESSONS LEARNED

The first six months after signing the Guarantee Agreement were the most difficult for the bank. The guarantee was a new risk manangement tool, which was unfamiliar to banks and businesses in the country. Consequently, it took time to build up a positive image and understanding of the concept, and to form a consensus among management on how to move forward. Over an 8-month period the bank developed and implemented its strategy, procedures and training for staff, and eighteen more months for the bank to fully incorporate the strategy to take advantage of the guarantee. After a sluggish start, the first loan was made on April 1, 2004.

WHAT WAS THE IMPACT OF USAID'S GUARANTEE?

USAID's partial guarantee is an important component of USAID/ Vietnam's economic growth strategy supporting enhanced private-sector competitiveness, which, over time, will accelerate Vietnam's transition to a more open and market-based economy. While some significant constraints remain, on the whole, the prospects for growth in the SME sector are significant. In the absence of this guarantee, many SMEs' ability to gain access to credit would not occur due to the local banking community's low risk tolerance and high collateral requirements.

ACB has taken a pioneering role, testing the market for demand and repayment of new loans for other banks.

New Lending Strategy for ACB

For ACB, this was a totally new lending activity. The guarantee reduced ACB's overall risk in its market activities. The ACB has taken a pioneering role, testing the market for demand and repayment of new loans for other banks. It opens up an investment opportunity for the bank as well as other financial institutions, once they understand the potential for profit from the loans.

Relaxation of Collateral Requirements–

With USAID's guarantee, ACB has succeeded in addressing the level of its collateral requirements for SMEs. The guarantee enables ACB to feel comfortable accepting various assets as collateral, helping the bank better serve SMEs' borrowing needs, while other Vietnamese banks continue to rely on more traditional lending requirements.

Expansion of Bank Clientele– As of March 15, 2005, ACB has disbursed approximately VND 21,910 million in new loans (approximately USD$1.5 million), which accounts for nearly one-third of the total amount of credit to be covered under the guarantee, as agreed to between USAID and ACB.

The ACB's growing number of loans to SMEs and the success of its lending activity to date demonstrate the sector's potential. The bank's continued involvement encourages other banks to test the market and increases the potential for competition among private-sector lenders. Greater participation accelerates Vietnam's transition to an open, market-based economy and should eventually enable Vietnam to trade at an international level.

Greater Potential for Market Growth and Trade– USAID's guarantee is helping push Vietnam's credit markets toward the free-flow of goods, services and capital, promoting broad-based growth in the country's economy. The ACB's "first to market" actions have drawn attention to the importance of financing activities in this sector and have been a motivating force for other banks to approach USAID regarding similar risk-sharing arrangements.

ACB's entry has benefited the credit market as a whole and created competition among the banks for new borrowers. It has also reduced the perception of risk in lending to Vietnam's smaller private businesses, in-vested in areas such as manufacturing, industrial equipment, construction, food processing, garments and textile.

Small and Medium-Sized Businesses Become Borrowers- Out of 35 customers that received USAID-backed loans from ACB, 30 are new customers of the bank. The loans were made by main branches in Hochiminh City and Hanoi. The businesses benefiting from ACB loans include clothing manufacturers, construction material firms, producers of plastic products, trading companies and a restaurant. The loans have been used broadly for working capital, and to pay for new trucks and cars to transport products, for new machinery, to pay for the import of medical equipment and to build a new factory.

Broader Community Benefits The emerging private sector has enjoyed robust growth and significantly contributed to increases in employment. Strong macroeconomic conditions combined with trade liberalization and regulatory reform should yield continued growth.

With the continued successful operation of the guarantee, the new focus is on financial sector improvements that support the sustainable growth of private enterprises. Part of this will come from USAID's technical assistance, provided to ACB to help shape its marketing strategy on a larger-scale, as well as for training on cash-flow lending skills and practices, credit risk management, guarantee operation supervision, and product development, to name a few. This should bring greater efficiencies to the operations of Vietnam's private banks and increase lending to SMEs, as well as improve the responsiveness of the financial sector to the credit needs of private small and medium-sized businesses. USAID/Vietnam now has three guarantees in place, covering not only small and medium-sized business development, but also educational lending.

While strict requirements remain on collateral levels for private-enterprise lending, the legal framework for the private sector must develop further. USAID's guarantee complements the country's efforts to mobilize private financial resources to speed Vietnam's business development, to increase the flow of goods, services, and capital in Vietnam's markets and to promote broad-based growth in the country's improved, but still transitional, economy. ■

MUNICIPALITIES FINANCE WATER PROJECTS

INDIA – BOND GUARANTEE - 2002

The lack of basic services such as clean water and sanitation is one of the harshest burdens of poverty. Improving local infrastructure can have substantially positive effects on the lives of both rural and urban residents. Women and children would no longer have to walk long distances to fetch water for their families and could instead develop a business or go to school.

The World Bank's September 2004 India Country Brief states that reducing poverty requires long-term, state-level action to upgrade and increase municipal infrastructure services. This analysis is consistent with USAID's objective in India to improve the environmental infrastructure and services delivered in select cities around the country.

Since 1996, several large municipalities in India have been able to access credit from domestic capital markets by issuing bonds to fund local infrastructure projects. The sale or "issue" of bonds is always rated to indicate the level of risk associated with a particular investment. By demonstrating good management, fiscal responsibility and steady sources of revenue, the municipalities received investment-grade credit ratings, were able to sell bonds and generate capital for new projects.

In contrast to large municipalities, the small- and medium-size towns, which relied heavily on government funds and guarantees, did not have records of repayment that would indicate the municipalities' ability to repay a debt obligation. Additionally, investors viewed the debt of smaller municipalities as a greater risk, which shrank the number of investors interested and demanded higher interest rates, which the smaller municipalities were unable to pay. As a result, the municipalities did not have credit ratings and were unable to access sustainable sources of credit for needed infrastructure projects.

Instead, small- and medium-size municipalities have had to rely on state-run financial institutions to subsidize their financial needs. By providing lower-than-market rates for credit, however, the government's intervention has hindered the development of private municipal financing for smaller towns.

Recently, the Indian government has made an effort to wean small- and medium-size municipalities off their dependence on subsidized funding. The government has limited the availability of its guarantees to cover loans, thereby reducing the amount of capital available to these towns. As a result, the municipalities have had to identify and develop alternate sources of financing.

WHY WAS A LOAN GUARANTEE NEEDED?

To support efforts to access private capital in India, USAID chose to design a pooled financing mechanism that could address the borrowing needs of smaller towns for the south-eastern state of Tamil Nadu where municipalities were unable to gain access to local bond markets. The model for this pooled municipal financing mechanism came from U.S. state-level bond banks that were developed to support small- and medium-size municipalities unable to access private sources of credit on their own. It would be the nation's first state-level pooled financing mechanism and the first issuance of a state-level bond to benefit India's smaller urban municipalities.

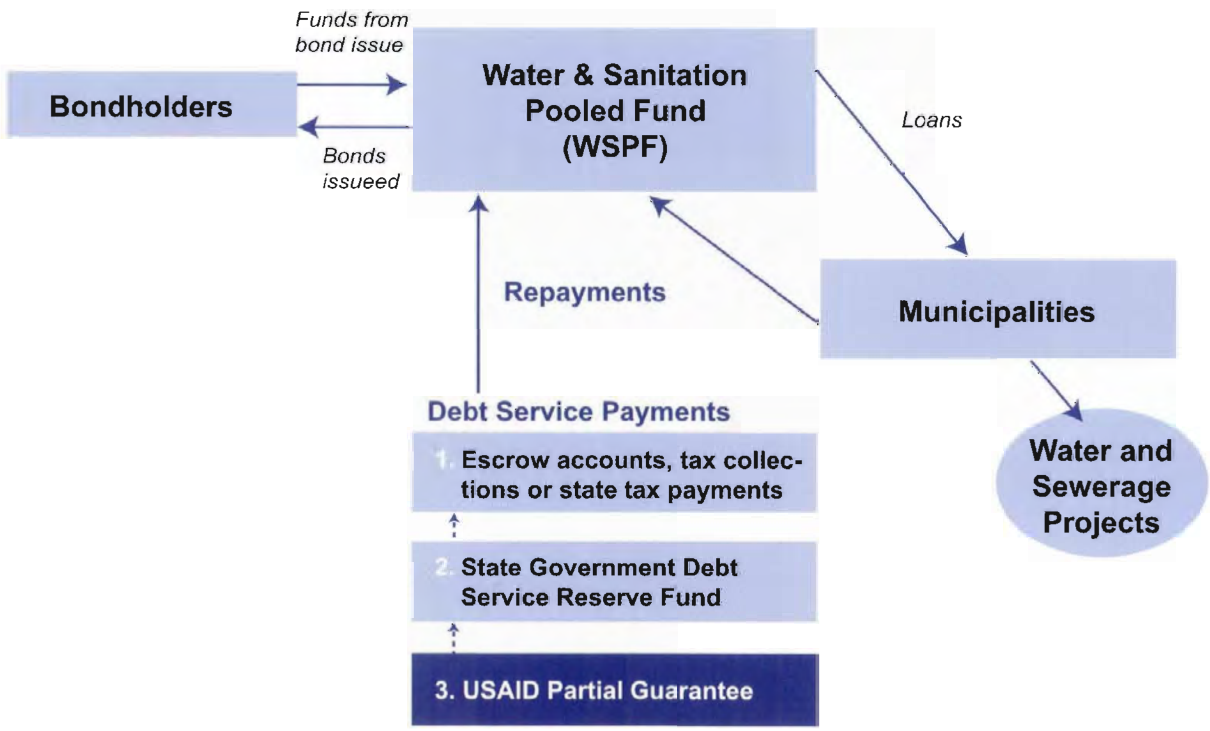
GUARANTEE TERMS

Bond Guarantee	2002
Type of Guarantee	Bond Guarantee
Guaranteed Party	Water & Sanitation Pooled Fund (WSPF)
Borrowers	Small & Medium-size Municipalities
Maximum Amount of Portfolio	US $6.4 million
Amount fully Guaranteed	US $3.2 million or 50% of repayments
Level of Guarantee Coverage	50% of Principal, Interest for up to 3 years
Term of Coverage	15 years
Currency of Loans	Indian Rupees

The primary goal was to attract India's private-sector investors and their capital by issuing a bond based on an innovative financing structure and complemented by USAID's partial guarantee. To create the structure, USAID worked with the Government of Tamil Nadu (GOTN), the federal government and three domestic financial institutions to ensure the successful development and operation of the pooled finance mechanism.

The diagram below shows the structure of the pooled financing mechanism, which has five major components, starting with the sale of the bonds to private investors who become bondholders. The proceeds from the sale are maintained in a fund called the Water and Sanitation Pooled Fund (WSPF), created specifically to lend the proceeds of the bond issue to select municipalities within Tamil Nadu. With these funds, the municipalities can initiate infrastructure projects and then make repayments back into the WSPF.

In the case of default by one of the municipalities, a tiered debt repayment structure ensures several layers of protection for the bondholders before they are affected by the loss. The following list provides the order of coverage:



1. The municipalities hold a portion of each payment in an escrow account, which is transferred over to WSPF on a scheduled basis and provides the first layer of protection in case of default;

2. If those funds are insufficient, the WSPF can access the municipalities' collections from tax payments received and/or tap the municipalities' own payments to the state;

3. Approximately one and a half times the annual debt service owed by the municipalities is kept in liquid securities as a state-funded Bond Reserve Fund (BSF) and replenished as needed.

4. If the initial funds of the BSF are not enough to cover a payment, a claim can be made on USAID's guarantee to replenish up to 50 percent of the amount withdrawn from the BSF.

The bond offer, with support from USAID's guarantee, generated $6.4 million in private capital, held by the Water and Sanitation Pooled Fund (WSPF). Since 2003, when the bond was sold, WSPF has been lending the proceeds from the sale to small and medium-sized municipalities to enhance the delivery of services to poor communities in Tamil Nadu. The projects are presented by the Tamil Nadu Urban Development Fund (TNUDF), a state-level financial intermediary created in 1996 to assist municipalities in financing the development of specific water and sanitation infrastructure projects. The loans are then repaid to the WSPF from the collection of user fees and taxes.

WSPF's funds are managed by the Tamil Nadu Urban Infrastructure Financial Services Ltd., a private asset management company created through a partnership between the TNUDF and three local financial institutions.

The WSPF addresses five major objectives:

1. Enable small- and medium-size municipalities to access credit for infrastructure development projects,

2. Develop a municipal debt market for smaller municipalities,

3. Establish credit ratings for municipalities in Tamil Nadu,

4. Lengthen the term of municipal bonds,

5. Act as a model to promote other longer-term municipal bond issuances.

This pooled financing mechanism provides a cost-effective way for villages, towns and cities to implement much-needed water and sanitation projects.

HOW WAS USAID'S CREDIT GUARANTEE USED?

Pooled financing is a novel form of municipal lending in India, and the lack of repayment history created uncertainty that increased the level of risk associated with the investment. USAID's bond guarantee filled two roles: first, it served as a credit enhancement to improve the credit rating of the municipal bonds. The higher rating drew attention to the bond offering, increased demand for the bonds from investors, lowered the cost of capital to participating municipalities and resulted in the successful sale of the bond. Second, the guarantee covers up to 50 percent of repayments to bondholders in the event of shortfalls in municipalities' repayments to the WSPF.

There are two particular reasons the pooling of funds made lending to smaller municipalities more appealing to private investors. The first is the lower transaction costs – for a municipality to issue a bond on its own is prohibitively expensive, but when coupled with other municipalities, a bond issuance becomes far more cost-effective. The second is the diversification of funding sources– in this case loans are available to seven municipalities so if one defaults the others payments and reserve funds can cover the loss.

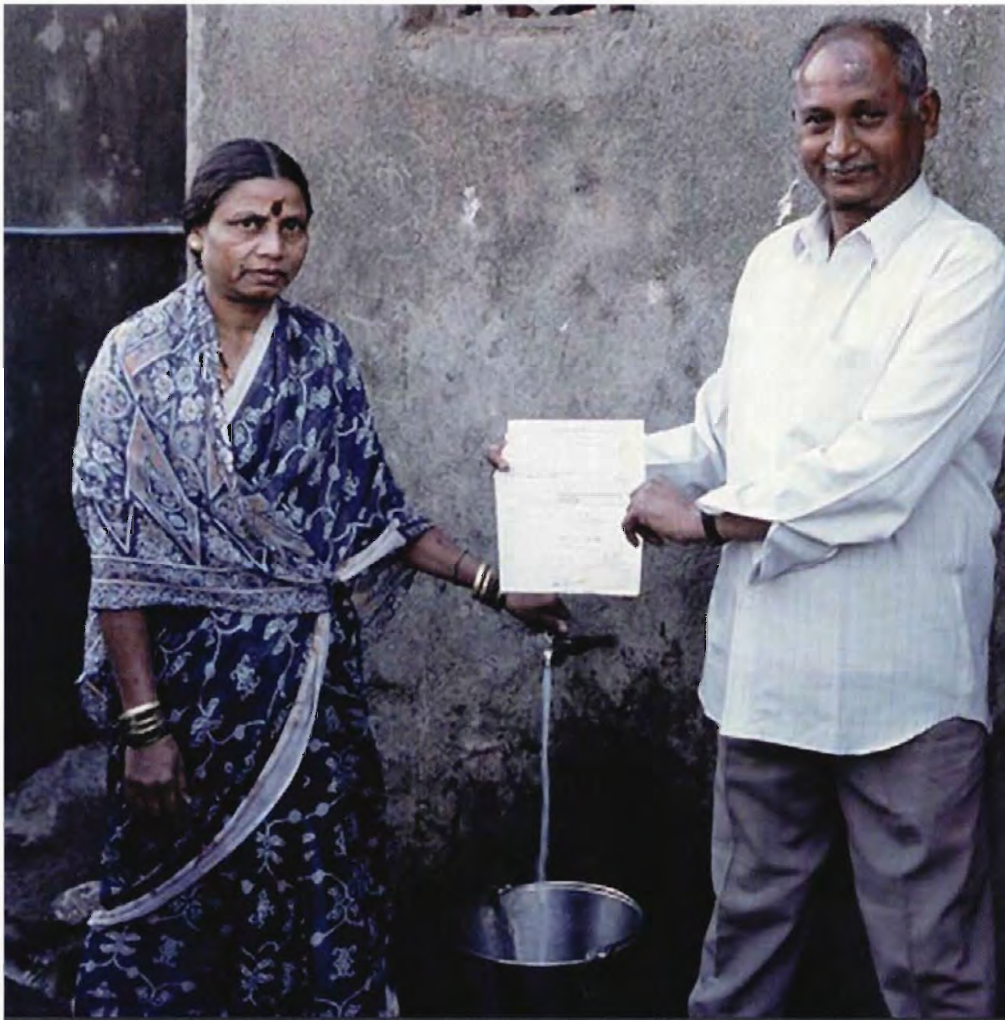
The guarantee complemented the assistance USAID was already providing on various urban-sector reforms, including:

- Building the informational and operational capacity of city officials and urban managers,
- Reforming fiscal management in small and medium urban municipalities, and
- Decentralizing the administration and delivery of local services.

WHAT WAS THE IMPACT OF USAID'S GUARANTEE?

The pooled financing mechanism has been a creative and successful mixture of private financing and government funding. The use of a bond guarantee corrects a market imperfection that hindered private-sector investments and therefore, further development of India's urban infrastructure. In addition, USAID/India's goal to develop bond financing for urban development projects and to improve the credit environment for municipal financing has shown strong signs of success. By providing a credit enhancement, the guarantee enticed both investors and municipal borrowers into the market. Although the guarantee focused on thirteen municipalities— six within the Chennai Metropolitan area and the other seven in the surrounding areas— it serves as a model for financing local infrastructure to India's four thousand plus municipalities. Following the implementation of this pooled financing, ten other municipalities have issued bonds and several more are in the process of obtaining a credit rating to issue their own bonds.

An example of the benefits from this type of pooled financing can be seen in the township of Valasaravakkam. Despite a population of 26,260, Valasaravakkam had no adequate water supply system, relying on open and bore wells and three above-ground tanks which were connected to 11 miles of piping. The system provided only two liters of water per person per day. Like many small communities, the financing needed to upgrade the township's water system was beyond the township's means.



An Indian couple, the ultimate beneficiaries of a USAID bond guarantee, display the new water tap at their home and their new water bill.

With the new bond issuance and guarantee, Valasaravakkam was able to take out a loan from the WSPF to lay pipe from a safe source to two new underground large-capacity tanks. The total project cost was expected to be $402,760, with 90 percent of the funds borrowed. This construction, combined with investments in new water pumps increased the local water supply per person from two liters to 35 liters per day.

Community Benefits – It is estimated that USAID's program, including the guarantee and technical assistance and the loans they produced, will benefit as many as 593,000 people in Tamil Nadu. The loans from the bond proceeds are being used for water supply, sewerage and other urban infrastructure investments. Clean water is now available to all the people in these towns, at least half of whom are poor. The improvements are expected to have a dramatic effect on public health.

Bond Market Development– The guarantee helped develop a bond market that could provide a sustainable credit environment for municipal borrowers, not the least of which was the extension of the loan terms, which lowered the costs and expanded the choices for Indian towns entering the market. The guarantee also created a new investment opportunity for the Indian private sector by demonstrating the financial viability of state-level municipal financing. Additionally, the deepening of India's credit market increased competition for both the investors, as lenders, and the municipalities, as borrowers. As a result of their participation, individual municipalities are developing a record of repayment which, over time, they will be able to reference when requesting a credit rating.

By reducing the risk of new market activities for investors, the guarantee may increase the potential for additional investment options in municipal financing. At least ten municipal authorities have already received investment grade credit ratings and six have already issued bonds. Several others are also in the process of getting a credit rating for potential issues.

India's first bond guarantee for state-level pooled financing provided enough experience for USAID/India to develop a second guarantee in the nearby state of Karnataka for a similar pooled-financing that will facilitate infrastructure projects for water and sanitation services. Additionally, USAID has just established a 10-year loan portfolio guarantee to cover loans for small-scale projects in renewable energy, energy efficiency, and water conservation/management. ■

LESSONS LEARNED

Several lessons are compiled here from USAID's experiences using partial credit guarantees. These lessons are offered as suggestions when considering or actively developing a guarantee.

Following the bullet-pointed list below are more specific lessons learned, taken from the examples in this guide. The lessons can apply to Mission objectives in many countries and sectors.

- Show potential partnering investors how USAID's credit guarantees have been used in other related lending environments, i.e. financial institutions or neighboring countries;
- Share success stories from other credit guarantees in the region, to demonstrate how the program can be successfully implemented.
- Build a close partnership with the bank's management during initial discussions and managing their expectations;
- Ensure the bank's business strategy is aligned with the objectives of the mission;
- Communicate the details of the guarantee agreement early on, including terms and conditions, fees (origination/utilization), reporting requirements, and procedures and timeframe for getting claims processed;

- Ensure there is a champion within the bank, among key department heads (e.g. credit risk analysis, commercial lending) or better, the bank president, to ensure a committed and concerted effort by the financial institution as a whole;
- Identify need(s) for training or technical assistance within the bank that USAID may be able to provide, such as:
  - Developing a "train-the-trainer" program for credit and loan officers and bank management;
  - Ensuring branch offices are aware of new products and strategies, and the tools to implement them;
  - Simplifying loan application procedures and loan requirements for borrowers;
  - Revising credit-risk guidelines to decrease interest rates, reduce collateral requirements and improve loan terms;
  - Reforming bank policies to reduce paperwork and levels of control;
  - Promoting legal reforms at the state level;
  - Creating specialized departments (e.g., microlending, mortgage lending) with the required resources and expertise.
  - Developing marketing and community outreach programs;

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- USAID guarantees are often used in conjunction with a Mission's technical assistance (TA). The TA is intended to help transfer knowledge to the lending institution to support them in learning to analyze loan requests from new sectors and for new borrower activities. In these cases, the guarantee should be designed in coordination with each financial partner to ensure they understand the short-term nature of USAID's technical assistance to help them learn about a new sector and how to operate in it. Additionally, TA providers should be made aware of the timeframe for this assistance and the duration clearly outlined in their Scope of Work, as part of the implementation description.
- One notable challenge for USAID came after a guarantee was in place and loans were being disbursed. The bank was reluctant to introduce USAID to borrowers benefiting from its coverage. USAID had not anticipated the bank's reaction. From the Agency's perspective, there was significant value in first-hand accounts of the impact the bank's loans have on the lives of the borrowers. From certain bank's perspective, if borrowers learned their loans were backed by a guarantee, especially from the U.S. Government, the bank risked increasing borrower defaults. Banks are sometimes equally uninterested in marketing their guaranteed loans, fearing non-payment as a result of the knowledge that it is backed by that guarantee.

  While USAID was interested in obtaining details of the impact bank's loans had on new borrowers, the bank chose to moderate their approach in public communications due to the bank's concerns, and, instead, referred to the guarantee as USAID "technical assistance". In future discussions with financial institutions on the development of a guarantee, it would be worthwhile to clarify USAID's expectations up front, as well as the roles and responsibilities of the financial institution, to minimize the potential for surprises once the guarantee is active.
- USAID/Nicaragua's success with their first guarantee encouraged the Mission to develop another. It was initially offered to the bank that received the first guarantee to follow on it and further boost lending to small and medium-sized businesses, but debate arose within the Mission on the value of providing another guarantee. The question was whether a second guarantee to the same lender for virtually the same activity met one of the ten guiding principles of USAID's credit guarantees, known as "additionally", which states that

a guarantee can only be provided for loans that would not be made without it.

During these internal discussions, the original bank pulled out of negotiations citing a reluctance to pay the origination and utilization fees as the reasons for its withdrawal. Looking back, the bank's first experience with agribusinesses through USAID gave it the knowledge and experience it needed to continue lending on its own to these types of borrowers and eliminated the need for a second guarantee.

- A program's success can be challenged by a conflicting understanding of the goals for TA and a guarantee. Resulting miscommunications can delay the development of the program until the financial institution and technical assistance provider work out a plan that effectively coordinates their efforts. A plan can list respective responsibilities or more specifically can include borrowers in sectors and geographic areas that financial institution would be comfortable lending to and that demonstrate an ability to service their debt.

A bank's privatization (transformation from a state-run into a private bank) can cause shifts in staffing and management connected with the bank's use and oversight of a guarantee. The lack of a consistent point of contact at the bank can negatively affect the relationship with USAID. Additionally, persistence in sharing information between each group can be key to helping maintain the lines of communication between USAID, its financial partner and any TA providers.

- Although sometimes neither a Mission nor it's financial partner can fully understand what the challenges of developing a guarantee will be when they begin a program, the availability of guidance and particular expertise from USAID/Washington can help ensure the successful development of a program, from concept to drafting of a guarantee agreement to it's use to cover new loans.

- The first six months after signing a guarantee agreement can be the most difficult for a bank. The guarantee, when first used, is new and unfamiliar to banks and businesses. Therefore, it can take time to build up an understanding of the concept to form a consensus among bank management before making any loans. Over an 8-month period, for example, one bank developed and implemented its strategy, procedures and training for staff. However, it took approximately eighteen months for the bank to roll out it's new lending activity and link each branch to fully incorporate the strategy and take advantage of the guarantee. After a sluggish start, the first loan was made on April 1, 2004. ■

In Egypt, a man looks out over the arid landscape where access to water is crucial to growth. Photo: USAID/Chris Ray

LIST OF ACRONYMS

BG ....Bond Guarantee

CEO................Chief Executive Officer

CRB ....Credit Review Board

DCA ....Development Credit Authority

EGAT/DC.........Economic Growth Agriculture & Trade/Development Credit (Bureau/Office)

GDP................Gross Domestic Product

IT ....Information Technology

LG....................Loan Guarantee

LDC ....Less Developed Countries

LPG ....Loan Portfolio Guarantee

NGO ....Non-Governmental Organization

ODC................Office of Development Credit

PG ....Portable Guarantee

PRA ....Poverty Reduction and Alleviation

PVO ....Private Voluntary Organization

RAEF ....Romanian-American Enterprise Fund

RLA..................Regional Legal Advisor

SME ....Small and Medium Enterprise

SO ....Strategic Objective

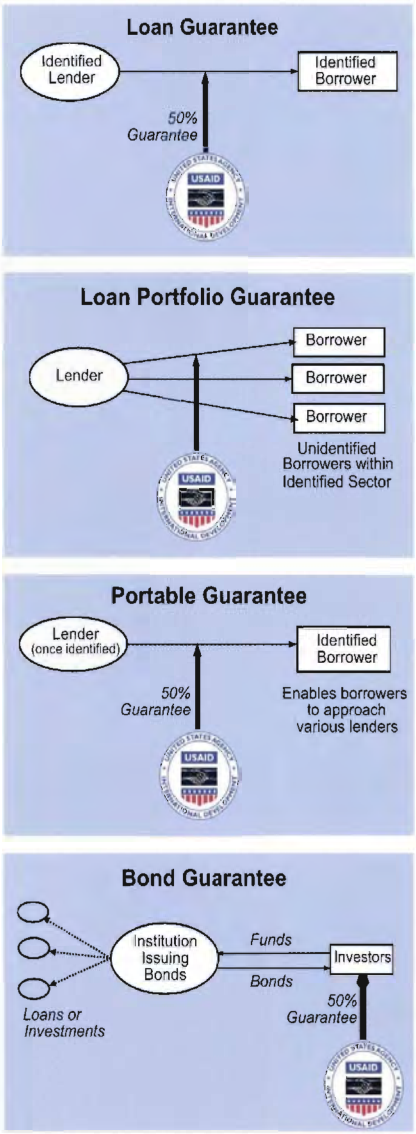
TA ....Technical Assistance

USAID.............United States Agency for International Development

USAID/W ....United States Agency for International Development/Washington

APPENDIX I: DESCRIPTION OF USAID CREDIT GUARANTEES

USAID GUARANTEE STRUCTURES



Loan Guarantees cover a single loan from a financial institution to a specific borrower for a particular activity. This guarantee is used when the borrower, lender, and use of the proceeds are known in advance, but where the loan would not be made without the guarantee.

Loan Portfolio Guarantees cover a pool of new loans from one financial institution to multiple borrowers in an area or sector specified by USAID. USAID shares the risk of default on the portfolio of loans to those borrowers to encourage the institution to extend credit to underserved sectors, activities and/or geographic areas. USAID relies on the lender to exercise due diligence in monitoring the portfolio of loans guaranteed.

Portable Guarantees are similar to loan guarantees except that the guarantee starts out with the borrower, not the lender. The lender has not yet been identified. A portable is used when a borrower cannot access credit due to excessively high interest rates, overly burdensome collateral requirements, or high level of risk associated with the requested loan as perceived by the financial institutions. If the borrower's request for a portable guarantee is approved, they receive a commitment letter from USAID to present to potential lenders describing USAID's intent to provide the lender, once identified, with a partial guarantee on its loan to the borrower. With the letter, the borrower has greater leverage in accessing affordable financing. Once a lender is identified, the portable becomes a loan guarantee to cover up to 50 percent of the lender's risk on the loan to the borrower.

Bond Guarantees help ensure that investors in a bond receive the stated repayments from their investment. These guarantees are used to support the sale of various types of bonds by financial institutions, private-sector corporations, or sub-national entities. Bond guarantees cover investors in a bond offering that will generate funds for specific activities such as local municipal infrastructure or utility projects. A bond guarantee can also support longer and better loan terms for borrowers of the proceeds than would normally be available from a bank. Although USAID bond guarantees are typically used in countries with relatively advanced capital markets, they can also be used to encourage investment in the first bonds issued to develop a bond market in less sophisticated financial systems.

FACTORS COMMON TO EACH GUARANTEE:

Design - flexible and can be tailored to the needs of a specific financial partner or project.

Management - developed and issued by USAID for projects that are financially viable, include prudent risk management and mitigation, and demonstrate a risk-sharing relationship with each private-sector partner.

Eligible sectors - can include any sector, from agriculture to health and microfinance to municipal finance.

Eligible lenders - non-sovereign financial institutions (foreign or domestic), capital market investors.

Eligible borrowers - private-sector enterprises and financial institutions, municipalities, and other sub-sovereign entities.

Terms - can cover loan lengths up to 20 years; commercial terms in local currency and/or U.S. dollar; risk is shared by USAID on up to 50 percent of a lender/investor's net loss on principal.

Fee - an origination fee is charged based on risk with development needs taken into account. A second fee (utilization fee) is charged annually, based on the loans under coverage.

APPENDIX II: FACTORS LIMITING ACCESS TO PRIVATE CAPITAL

There are a number of reasons why banks in developing countries do not lend a higher percentage of deposits to entrepreneurs, private-sector businesses and developmentally beneficial activities. While a full discussion of the reasons is beyond the scope of this document, a brief summary will highlight the fundamental obstacles that limit the flow of credit and the potential impact of loan guarantees on credit markets in less-developed countries (LDCs).

Outside of those countries, there has been a long-standing belief that the low volume of lending from the private sector is due to a lack of funds available in the banking sector of developing countries. In reality, the opposite is true. The liquidity within the banking system in many developing countries amounts to a significant percentage of GDP. Many banks maintain 50% or more of their total deposits in liquid assets, such as cash positions, inter-bank loans, central bank debt or short-term government securities and generally lend only a modest portion of their total deposits to private-sector borrowers.


In Morocco, many small family-owned businesses produce and sell hand-stitched rugs to local and international markets.

This represents a massive failure of the financial system to allocate capital to its most productive uses. U.S. banks, in comparison, keep roughly 6% of their total deposits in liquid assets, and the bulk of their capital is used for non-sovereign loans.

Due to heightened macroeconomic risk and volatility, it is prudent for banks in developing countries to keep a higher percentage of deposits in liquid assets than in developed countries. The likelihood of a run on the banks or an economic crisis that triggers a wave of defaults is greater in developing countries. Banks therefore maintain substantial liquid assets in order to withstand a sizable withdrawal of deposits while maintaining solvency during periods of economic turmoil.

Due to this heightened macro-economic risk and volatility, central banks also impose higher reserve requirements. Nevertheless, banks often maintain reserves at levels well in excess of the required amounts. There are several reasons why banks in LDCs maintain excess reserves and do not lend more to the private sector:

First, the legal and judicial environment is deficient and property rights are not adequately protected. It is very difficult (and sometimes impossible) to enforce contracts in developing countries. The process is time-consuming and costly and the outcome is not always assured. As a result, lenders are not confident of receiving repayment if a borrower defaults. To help ensure that borrowers will pay back their loans, lenders impose very high collateral requirements which borrowers often do not have adequate assets, such as legal title to privately-owned land or equipment, to satisfy.

Second, governments in LDCs often run large deficits, which drive up interest rates and crowd out local investment. Banks are able to make a good profit taking in deposits and using them to purchase government bonds, so they are less inclined to search for lending opportunities with entrepreneurs and private firms.

As borrowers, small business owners like this one in Kenya are a challenge for many private banks, which lack historical information about the client's ability to repay a loan.

Third, banks have great difficulty ascertaining which borrowers are good credit risks due to a high degree of asymmetric information. There are few if any credit bureaus that provide lenders with the credit history of prospective borrowers and whether they have repaid prior debts. As a result, banks do not know nearly as much about a borrower's operations and likelihood of repayment as the borrower knows. Banks also lack reliable documentation and data about borrowers, including financial statements and financial records demonstrating a borrower's cash flows and therefore ability to earn enough revenue to repay their loan.

Market imperfections often arise when there is an imbalance in the amount of information available. This is known as 'asymmetric information', when lenders do not know nearly as much about a borrower's business prospects and likelihood of repayment as the actual borrower does. It is very difficult for LDC banks to distinguish good borrowers from bad borrowers.As a result, banks may require substantial collateral and they may charge higher interest rates to offset this risk. Creditworthy borrowers may be denied credit because they are unable to meet such collateral requirements or pay such high interest rates.

Fourth, bankers in LDCs lack experience lending to the private sector, which hinders financial intermediation. Many banks in developing countries were privatized recently or remain state-owned and the bankers have not developed adequate skills for analyzing credit risks in certain sectors and conducting cash-flow analyses.

In addition, banks often perceive new types of lending as inherently risky and are reluctant to devote the time and resources needed for new types of lending, even if improvements have been made to the country's legal framework.

Even when credit is available to businesses in LDCs, the loans must be repaid in a very short time frame. Without longer repayment periods it is difficult to finance the purchase of new equipment or technology because such investments may not yield sufficient revenues in the short-term to repay a loan.

High collateral requirements are another burden for prospective borrowers. Banks make lending decisions largely based on the value of assets pledged by a borrower rather than a borrower's expected revenues and cash-flows. Borrowers often must satisfy collateral requirements well in excess of 150 percent of the loan amount. This precludes most potential borrowers from debt financing and, in particular, those desiring to starting a new business.

Partial loan guarantees are a tool that can encourage LDC banks to serve as financial pioneers and provide loans to new sectors or borrowers or offer more innovative financing terms. Partial loan guarantees reduce market-entry risks for lenders contemplating new products and new client groups, reducing aversion to new types of lending. Financial institutions develop skills from partially guaranteed loans because the process of making new loans forces banks to conduct due diligence and build internal risk-assessment abilities as well as loan monitoring skills. In the course of undertaking new loans, banks may prepare new credit guidelines, hire new loan officers, conduct evaluations of new types of collateral or establish internal databases and systems that allow for greater efficiency and more comprehensive analyses of new types of borrowers. Through learning-by-doing, banks are better able to identify good borrowers and this allows them to expand their lending activities over a sustained period of time.

The transformation of credit markets will require tackling these market imperfections and, on a micro-level, will also require that individual financial institutions within LDCs overcome high risk perceptions and serve as financial pioneers in new markets. As legal and policy reforms are implemented, banks will become more inclined to increase their lending to the private sector.

IMPACT OF A PARTIAL GUARANTEE ON THE TERMS AND CONDITIONS OF A LOAN

A partial loan guarantee reduces a lender's perceived risk on new loans by lowering the lender's potential loss from defaults. Guarantees from triple-A rated guarantors also enable banks to lower the reserves they need to set aside for a loan. This allows banks to earn a greater return on equity. Lenders may also agree to different terms and conditions per loan due to the presence of a guarantee such as reducing collateral requirements, thereby allowing more businesses or entrepreneurs that lack substantial collateral to obtain loans. The guarantee can also encourage the lender to offer a longer repayment period enabling borrowers to make investments in equipment, technology or infrastructure that enhance productivity. Without a long repayment period, borrowers will not have enough time to generate sufficient revenue from costly investments to repay loans.

NOTES

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