

Linking Financial Service Providers to Commercial Capital: How Do Guarantees Add Value?

In microfinance, experimentation with loan guarantees began largely as an attempt to demonstrate to local banks that microfinance institutions (MFIs) are creditworthy. Though loan guarantees are far less common than other funding instruments, such as debt, equity, and grants, they are beginning to be used more often. This Brief is based on a joint CGAP/USAID study of 96 transactions executed by eight guarantor agencies between 1988 and 2005, with most transactions made after 2000 (Flaming 2007).

WHAT IS A LOAN GUARANTEE?

In this Brief, “loan guarantee” refers to a type of credit guarantee that backs up a loan to a single MFI from a bank or other lender. Such loan guarantees are a form of insurance that covers a lender—typically a commercial bank—against default on its loan to an MFI.

WHY DO FUNDERS USE LOAN GUARANTEES?

Most MFIs can reach significant scale in the long term only by tapping into local deposits and bonds and by borrowing from local banks. However, many MFIs are prohibited from taking deposits, and many local bond markets are underdeveloped. Funders hope that issuing loan guarantees will facilitate MFIs’ access to commercial funding—mainly local bank loans. Most guarantees are issued by organizations, or departments within funding agencies, that are mandated and funded specifically to provide loan guarantees.

Funders expect that guarantees will do the following:

- **Facilitate access to bank loans.** Guarantees are meant to encourage loans from banks that would not otherwise lend to MFIs because the MFIs are not considered creditworthy. The idea is that by covering all or part of banks’ credit risk, guarantees will increase banks’ appetite to lend to MFIs in the future without a guarantee. Funders also seek to demonstrate the creditworthiness of MFIs to the broader banking sector. Though most guarantee programs focus on access to local loans, guarantees can be used to bring in international commercial capital.

- **Leverage funders’ capital.** By using guarantees, funders hope to unleash access to amounts of funding greater than the value of the guarantee.

Why do MFIs use guarantees?

- Promise of long-term relationship with a local commercial bank
 - Funding diversification
 - Growth financing, especially for MFIs not permitted to take deposits
 - Prestige of association with an international institution
- **Mitigate foreign exchange risk.** Many MFIs lack effective mechanisms to manage the foreign exchange risk created if they borrow in hard foreign currency and lend to their clients in local currency. A guarantee structure can help mitigate this risk. The guarantor can fix the guarantee amount in hard currency, while the local bank lends to the MFI in local currency, leaving the MFI with no foreign exchange risk.
 - **Overcome regulatory barriers.** In a few countries, regulations restrict foreign borrowing or make it expensive. Loan guarantees can facilitate local loans without creating foreign obligations for MFIs.

WHAT HAS BEEN THE EXPERIENCE WITH LOAN GUARANTEES TO DATE?

Benefits

- **Loan guarantees helped MFIs get loans from local banks that otherwise would not lend to them.** Beyond the guarantee, guarantor agencies provided transaction expertise and credibility that enhanced local banks' perception of MFIs. For nondeposit-taking institutions, such local loans may be one of the few alternatives to finance growth.
- **Guaranteeing loans by local banks in local currency helped MFIs avoid taking on foreign exchange risk.** Eighty-two percent of guaranteed loans were issued in local currency.
- **Loan guarantees helped overcome legal or regulatory barriers.** In India and Morocco, countries where regulations restrict foreign borrowing by nonprofit organizations, guarantees facilitated local loans. The additional risk coverage offered by guarantees also helped banks comply with banking regulations that limit their unsecured lending.

Limitations

- **Guaranteed loans were costly for MFIs.** The terms of the loans were the same as those to typical small and medium business borrowers in the country: interest rates were higher than the prime rate and real collateral requirements on unguaranteed portions of loans were high. On top of that, MFIs had to pay guarantee fees.
- **Guarantors did not measure all-in costs of providing guarantees.** Guaranteeing small bank loans to MFIs required subsidies that often were not recognized or measured. The fee income from small transactions was insufficient to cover the cost of issuing the guarantee. Appraising MFIs was expensive for the guarantors, especially in the absence of reliable risk ratings. Also, guarantor agencies often had to provide many supporting services related to closing a guarantee transaction because of the inexperience of the lenders and MFIs. While these subsidies may be justified by the benefit produced by the guarantee, they should be quantified.
- **Loans provided above the guarantee amount typically required additional collateral.** In many cases, guarantees did not increase banks' comfort

level for risk taking. MFIs had to pledge other real assets to cover the unguaranteed portion of the loan (e.g., land, cash, securities, or letters of credit).

- **Guaranteed loans' contribution to MFIs' total assets was small.** The guaranteed loans made a relatively small contribution to MFIs' total assets—less than 5 percent in most of the transactions.

ARE GUARANTEED LOANS AN EFFECTIVE FUNDING STRATEGY FOR MFIs?

Most guarantors consider loan guarantees a success if MFIs are eventually able to borrow from local banks without a loan guarantee at better-than-retail conditions. The results are mixed. The extent to which guarantees benefit MFIs is closely linked to the nature and maturity of both the institutions themselves and the markets in which they operate.

For most MFIs, the benefits were modest—the guaranteed loans were a small percentage of the MFI's assets and were costly. Some MFIs chose not to increase their direct borrowing from local banks after the end of guarantee. Over time, MFIs included in the study funded their growth from other sources, with the exception of markets where banks deliberately established a business line of lending to MFIs.

The analysis of the transactions reviewed for the CGAP/USAID study suggests that, in the vast majority of markets and where mobilizing deposits is an option, guaranteed commercial bank loans are not a viable long-term source of significant funding for MFIs with serious growth plans. However, guarantees have been useful for small, nondeposit-taking MFIs that are unable to attract adequate capital from local or international capital markets and have few alternatives to fund their growth. They also have opened the door to subsequent lending, helped overcome regulatory obstacles to foreign financing, and facilitated loans in local currency.

REFERENCE

Flaming, Mark. 2007. "Guaranteed Loans to Microfinance Institutions: How Do They Add Value?" Focus Note 40, Washington D.C.: CGAP, January.

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