Concept Brief:

Loan Guarantees

Concept Brief: Loan Guarantees

Financial Intermediation in Pro-Poor Investment Deals

This is the first concept brief in a series on financial intermediation in small-scale, pro-poor investment deals in developing countries. This series will highlight approaches that mobilize private capital from banks and other financing institutions to support micro, small, and medium enterprises (MSMEs) through leveraging resources, integrating incentives, and mitigating risk in deal and investment structures.

The Challenge of Securing MSME Financing

Micro, small, and medium enterprises (MSMEs) in developing countries have tremendous potential to increase economic growth and to support a broad array of development objectives.

However, MSME entrepreneurs often face barriers to accessing the necessary financing to start or expand their enterprises. Many MSMEs have capital requirements that exceed microfinance ceilings but they often cannot access bank or similar financing without established credit histories, documented business track records, and/or collateral that can be many times the amount of the financing they require. The challenge of meeting bank and other financial institution lending requirements are further compounded by these institutions' lack of familiarity with pro-poor business models and often the technologies involved as well as their lack of interest in getting involved in secondary markets for used technologies in the event of loan defaults. As a result, banks and other financial institutions tend to bypass the MSME market due to the actual or perceived risks and the anticipated transaction costs. This situation effectively excludes MSMEs from accessing mainstream financing, leaving few if any alternatives beyond the common "friends and family" sources, since informal financing from moneylenders or similar sources is typically offered at significantly higher interest rates.

Loan Guarantees as a Risk Mitigation Tool

The misalignment of bank financing requirements and MSME financing needs can be addressed through deal structures designed to make it easier for banks and other financial institutions to adjust their standard procedures and risk assessments to sufficiently lower the costs and risks of financing MSMEs.

One mechanism, guarantees of loans made by banks or other financial institutions, are particularly effective. Loan guarantees are used for debt financing, including for capital expenditure needs as well as for working capital purposes. Loan guarantees can be administered through guarantee fund or similar structures. Although there are variations in these structures, in general, the entity offering the loan guarantees absorbs a percentage of the risk that banks or other financing sources make to MSMEs, thereby providing them with a degree of protection from the downside risk by covering a portion of the financial loss in the event of a loan default.

Loan guarantees are most appropriate to use when banks or other financial institutions cannot evaluate risks effectively or will not assume the risks associated with particular deals or deal types. Risks vary depending on the nature of the deal but risk categories include those specific to individual MSMEs as well as risks that are external to MSMEs but which nevertheless could negatively impact operations and profitability and thus the banks or other entities' ability to be repaid. Examples of risks include misjudging the market demand

and affordability for a new service, failure of the MSMEs' suppliers to deliver inputs in a timely manner given poor infrastructure, political instability, floods or droughts, and/or problems with MSMEs' technology performance and reliability.

We advocate for the use of partial loan guarantees as opposed to full loan guarantees. Partial loan guarantees require banks and other financial institutions to use their own capital in MSME deals and, as a result, engage more intentionally with the investment deals. With their own capital at stake, banks and other financing institutions are more likely to learn from the assessment process in a manner that will leave them better positioned to finance similar MSME deals in the future and to extend other financial products and services to MSME clients.

Loan Guarantee Concept

Loan Guarantee Funds

Loan guarantee funds offer a systematic approach to provide loan guarantees. Structures can vary depending on the objectives of the fund but all share general features, including the need for seed capital as well as partnerships with banks and/or other financing institutions. Funds can be set up and/or operated by a variety of different entities, ranging from philanthropic institutions to governments to nonprofit and other nongovernmental organizations, including social impact investors. In all structures, once a loan is repaid successfully the funds are released from their obligation, freeing up capital to repeat the process with additional MSME loans.

Guarantee funds leverage their capital, mobilizing significantly more capital from local banks and other financing institutions than would be available if the guarantee funds were to lend directly since they can guarantee a greater value of loans than their capital holdings. The amount of leverage achieved will be a function of real or perceived balance sheet of the fund.

The allocation of responsibilities between the fund operator and bank and financing institution partners varies depending on their specific objectives and preferences. Some guarantee fund arrangements will create restrictions on the type of borrower, interest rates, fee structures, and the purpose of the loans as well as specify requirements for the due diligence processes, borrower duties (e.g. attending business training), and loan monitoring procedures.

Important Considerations When Using Loan Guarantee Funds

While loan guarantees can be effective risk mitigation tools, the design of the funds must avoid pitfalls that undermine their effectiveness. It is important that the funds facilitate MSME financing that is additional, meaning that the MSMEs would not have been able to secure financing from banks and similar financing institutions in the absence of the fund. Focusing on additional financing for MSMEs reduces concerns of bank subsidization.

It is also necessary to set up clear loan guarantee fund management and administration parameters to ensure that the fund can be sustainable. This is especially true since loan guarantee funds can leverage many times the amount of available capital in the fund, necessitating careful management of contingent liabilities that will be called upon in the event of loan defaults. Part of the funds' own risk management includes the mix of more established with more innovative investment deals, balancing various risks related to technology, end-user markets and affordability, and business models. Funds can also expand their roles by pursuing other risk management approaches, such as working with technology suppliers on equipment guarantees, servicing, and buy-backs as well as supply chain strengthening. Many of these issues are particularly important for pro-poor projects.

Recovery of transaction costs involved in due diligence, following through with borrower capacity building and other support, and/or monitoring must be accounted for and designed into loan guarantee funds. While it is not always the duty of loan guarantee funds to provide these functions directly, programs and projects that are intended to provide this type of support must be arranged.

Another important consideration is the degree to which loans should be guaranteed. While different deals engender differing levels of risks, we believe that partial loan guarantees of loans should be used over full loan guarantees when structuring MSME financing arrangements with banks and other financing sources. Our experience has shown that initially high degrees of loan guarantees can be important to facilitate the financing of new project types, but can be reduced significantly with satisfactory loan and deal successes. Partial loan guarantees allow existing guarantee fund capital to be leveraged for more deals and they encourage deeper bank engagement and learning, which can increase the likelihood that banks and similar financing institutions adopt more inclusive business operating practices.

Benefits for Inclusive Market Development

Systems-Level Development Effects

- Promotes local economic development and encourages more inclusive and functional market systems through the extension of mainstream financing to previous excluded borrowers
- Mobilization of local private capital helps with the shortfall in philanthropic and development capital needed to address development challenges

Local Development Effects

- MSMEs can reduce their cost of capital and, over the loan term, establish a credit history that can be used in the future to secure additional financing.
- Banks gain experience working with MSMEs that they would not have otherwise considered as creditworthy or a source of new clients.