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DESIGNING LOAN GUARANTEES TO SPUR GROWTH IN DEVELOPING COUNTRIES

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Introduction

There is widespread recognition by the international donor community that a greater role for the private sector is essential for tackling many of the development challenges outlined in the ambitious Millennium Development Goals.[1] Direct assistance from donor governments will not be sufficient to meet these challenges, and innovative ways to leverage private sector resources are needed. In recent years several multilateral development banks and bilateral development agencies have introduced partial loan guarantees as part of their assistance efforts. These loan guarantees are largely designed to stimulate private sector lending that will advance the Millennium Development Goals. The guarantees are often provided to lenders in developing countries for loans denominated in the domestic currency as opposed to U.S. Dollars or Euros. The U.S. Agency for International Development (USAID) has been particularly active in using partial loan guarantees under its Development Credit Authority (DCA).[2] During the past three years, USAID has provided approximately 100 partial loan guarantees to lenders in over 30 developing countries for projects spanning a wide range of sectors.

This paper explores the development rationale for partial guarantees of domestic currency loans in less developed countries (LDCs).[3] By way of background, the paper briefly discusses the deficiencies in credit markets in developing countries and how loan guarantees can help tackle some of these deficiencies. The paper then presents some fundamental issues surrounding the design of an effective loan guarantee program and how USAID has addressed these issues in the design of its DCA loan guarantees. The paper also examines the potential impact of partial loan guarantees on several types of businesses and sectors that are important for development: small and medium enterprises (SMEs), micro-enterprises, housing and infrastructure.

Condition of Credit Markets in Developing Countries

The absence of robust credit markets in developing countries is a significant impediment to sustained economic growth. Productive economic activity

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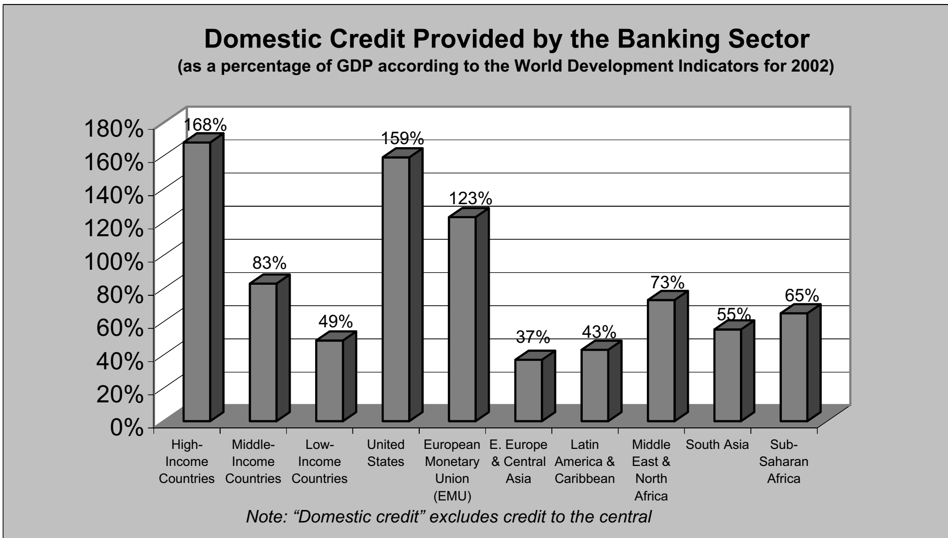
[1] The Millennium Development Goals announced by world leaders in September 2000 contemplate the eradication of extreme poverty and hunger, the provision of universal primary education, significant reductions in child mortality and diseases, cutting in half the number of people without access to safe drinking water, and securing adequate housing for 100 million slum dwellers – all by 2015. http://www.developmentgoals.org.

[2] The Development Credit Authority is the legal authority under which USAID can issue partial credit guarantees, including guarantees of loans, bonds and other forms of debt.

[3] Throughout this paper the term LDCs will be used to refer to all developing countries, both low-income and middle-income.

is severely limited by the inability of entrepreneurs, small businesses and individuals to obtain loans. In contrast, there is widespread access to credit in most developed countries, and it is relatively easy for entrepreneurs to get a loan to start a business, for small businesses to get a loan to expand their operations or for individuals to get a loan to purchase a home.

Empirical studies have demonstrated that credit to the private sector plays a crucial role in economic growth, and developed countries enjoy higher growth rates partly because they have more vigorous credit markets.[4] In 2002, annual domestic credit provided by the banking sector in high-income countries averaged 168% of GDP.[5] For the U.S. it was 159% of the U.S. Gross Domestic Product (GDP) – this amounts to over $16 trillion in bank lending to the private sector. In contrast, the 2002 annual domestic credit provided by the banking sector in middle-income countries averaged just 83% of their GDP and for low-income countries the average was 49% of their GDP. The disparity between the level of credit in LDCs and high-income countries is even greater than these numbers suggest, because banks are the primary source of credit in LDCs while high-income countries have sizable bond markets and other significant non-bank sources of credit.



[4] See generally Levine, Ross; Loayza, Norman; and Beck, Thorsten. 2000. "Financial Intermediation and Growth: Causality and Causes." *Journal of Monetary Economics*. 46: 31-77; and The World Bank. 2001. *Finance for Growth: Policy Choices in a Volatile World*. World Bank Policy Research Report. New York: Oxford University Press, Inc., Chapter 1.

[5] The World Bank. 2004. *World Development Indicators 2004*. Washington, DC, 270-273. Domestic credit is defined as "Domestic credit provided by the banking sector to various sectors on a gross basis, with the exception of credit to the central government, which is net. The banking sector includes monetary authorities, deposit money banks, and other banking institutions for which data are available."

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 investments in 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% of the loan amount. This precludes most potential borrowers from debt financing and, in particular, those desiring to start a new business.

The low-volume of lending to the private sector in developing countries is not primarily due to a lack of funds in the banking sector. Banks in LDCs generally lend only a modest portion of their total deposits to private sector borrowers, while a large percentage of their deposits remain in liquid assets such as cash positions, inter-bank loans, central bank debt or short-term government securities. For example, U.S. banks keep roughly 6% of their total deposits in liquid assets and the bulk of their capital is used for non-sovereign loans. By contrast, many banks in developing countries maintain 50% or more of their total deposits in liquid assets and provide minimal credit to the private sector. The liquidity within the banking system in many developing countries amounts to a significant percentage of GDP. This represents a massive failure of the financial system to allocate capital to its most productive uses.

There are a number of reasons for the failure of banks in developing countries to lend a higher percentage of deposits to private sector businesses and entrepreneurs. A thorough discussion of these reasons is beyond the scope of this paper, but a brief summary is needed before analyzing the potential impact of loan guarantees on credit markets in developing countries. Due to heightened macroeconomic risk and volatility, it is prudent for banks in developing countries to keep a high percentage of deposits in liquid assets. The likelihood of a run on the bank or an economic crisis that triggers a wave of defaults is greater in developing countries, and banks in LDCs sensibly maintain substantial liquid assets so that they can withstand a sizable withdrawal of deposits and maintain solvency during periods of economic turmoil. Central banks also impose higher reserve requirements due to this heightened macroeconomic risk and volatility. Nevertheless, banks often maintain reserves 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.[6] As a result, lenders are not confident they can get repaid if the borrower defaults. To help ensure that the borrower will repay, lenders impose very high collateral requirements which borrowers often cannot satisfy because they do not have adequate legal title to assets such as their land or equipment.

Second, governments in LDCs often run large deficits and this drives up interest rates and crowds-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.

Third, banks have great difficulty ascertaining which borrowers are good credit risks due to a high degree of asymmetric information. Banks do not know nearly as much about a borrower's operations and likelihood of repayment as the borrower knows. Banks lack reliable information and data about borrowers. There is an absence of accurate financial statements and financial records that can demonstrate that a borrower has been earning enough revenue to repay a loan. There are few if any credit bureaus that provide lenders with the credit history of prospective borrowers and whether they have repaid prior debts.

Fourth, bankers in LDCs lack experience lending to the private sector and this 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 risk in certain sectors and conducting cash-flow analysis.

Need for Financial Pioneers in LDCs

The transformation of credit markets in LDCs will require tackling the aforementioned fundamental obstacles to the flow of credit, and, on a more micro-level, it 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. However, banks often perceive new types of lending as inherently risky and are reluctant to devote the time

[6] For excellent data on the difficulties in contract enforcement in LDCs, see The World Bank. 2004. *Doing Business in 2004*, Chapter 4.

and resources needed for new types of lending even if improvements have been made to the legal framework. Similar to many LDCs today, the United States at the turn of the 20th century had a large informal sector in which most small businesses lacked access to affordable credit. As collateral laws were improved a new wave of lending to entrepreneurs and small businesses did not spontaneously emerge. Instead, one bank, Bank of America, slowly pioneered lending to the traditionally marginalized small business sector and figured out how to make such lending profitable.

Through aggressive outreach efforts it took in billions in deposits of personal savings that otherwise would have remained "under the mattress". It used such deposits to make loans to middle-income and low-income individuals that were previously denied credit. Entrepreneurs and small businesses got loans for the first time and they proved to be good customers that continued to borrow from Bank of America. In the 1920s Bank of America was just a small Italian bank that lent to Italian immigrants, and by the 1950s it was the largest bank in the United States with over $7 billion in deposits (in 1950s dollars) and over 5 million separate customer savings accounts.[7]

Over time, other banks followed Bank of America's lead and initiated new lending programs to the small business sector. U.S. banks learned how to lend profitably to small businesses and individuals, and the volume of loans going to these traditionally credit-marginalized groups expanded exponentially. This new lending helped drive economic growth. As the burgeoning field of behavioral economics has increasingly demonstrated, financial markets often act in such a herd-like manner. Once one bank jumps into a new sector or line of business, this impacts the perception other banks and they are more likely to undertake investments in that same sector or line of business. Similar to the role of Bank of America in fostering lending to small businesses in the U.S., LDCs need some banks to serve as pioneers for lending into new sectors.

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, thus 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

[7] James, Marquis and James, Bessie Rowland. 1954. *Biography of a Bank: The Story of Bank of America*. New York: Harper.

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.[8]

Designing Loan Guarantees to Develop Credit Markets

Loan guarantees should be designed to correct market-failures rather than distort markets. In the case of partial loan guarantees, if a primary objective is enhancing economic growth then the loan guarantee program should be meet the following tests:

a) a market imperfection exists, resulting in a lack of financing for credit-worthy borrowers (i.e. borrowers that are likely to earn sufficient revenues to repay the loan);
b) the loan would not have been made but for the loan guarantee (this if often referred to as “additionality”- the loan is additional to what would take place in the absence of the guarantee); and
c) the loan guarantee will not create incentives for significant moral hazard (i.e. reckless conduct) with respect to the guaranteed lender or the borrower.

In addition to satisfying these tests, partial loan guarantees designed to spur growth should also try to foster sustained lending. Guarantees will be more beneficial if lenders continue lending to new borrowers or new sectors once the partial guarantee is no longer available to them.

Market Imperfections

Without market imperfections there is little basis for government intervention – creditworthy borrowers are able to obtain financing. Imperfect credit markets exist when creditworthy borrowers are unable to obtain loans. In every economy there are market imperfections, but they are particularly severe in developing countries. There is generally less widespread and easily disseminated information about businesses in LDCs. Much economic activity remains in the informal sector, and audited financial statements, credit ratings and well-documented records of a business’ operations are often lacking. There is extensive credit rationing and redlining by banks. For example, banks often

[8] For a general discussion of “learning by doing” and the potential for financial sector deepening from loan guarantees, see Doran, A. and Levitsky, J. 1997. *Credit Guarantee Schemes for Small Business Lending – A Global Perspective.* Prepared for the UK Overseas Development Administration. London: Graham Bannock and Partners Ltd., 9, 11, and 31.

decide not to lend to borrowers in certain geographic areas regardless of their creditworthiness.

Market imperfections often arise when there is asymmetric information – 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.[9] 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.

Nobel laureate economist Joseph Stiglitz and Andrew Weiss have presented a compelling model of how credit rationing by banks, particularly in LDCs where the degree of asymmetric information is amplified, is likely to be pervasive and reflects a natural state of affairs in the loan market.[10] Their model notes that banks respond to the risks stemming from asymmetric information by charging higher interest rates, and this may create adverse selection and moral hazard. High interest rates relative to a banks' cost-of-funds are commonplace in LDCs (in Brazil lending spreads are above 50 percentage points a year on personal loans).[11] Many of the creditworthy borrowers are unwilling or unable to pay such a high interest rate, while the riskier borrowers are willing to incur a high interest rate (the risky borrowers think the high interest rate is a good deal but the creditworthy borrowers think it is a bad deal). If banks continuously raise their interest rates due to asymmetric information then they will increasingly suffer from adverse selection – the creditworthy borrowers will forego the loans and the bank will be left primarily with very risky borrowers, ultimately resulting in high default rates. Also, higher interest rates create moral hazard because the borrowers will have an incentive to undertake riskier activity in order to generate the higher revenues needed to repay the loan. The riskier activity will produce greater defaults. Therefore, banks will at some point choose not to increase interest rates despite excess demand for loans at such interest rate. Instead, banks will limit the amount that they lend and many creditworthy borrowers will not have access to loans. Banks may prefer a smaller, safer portfolio than a portfolio with higher interest rates.[12]

[9] The growth of microfinance institutions and other informal lenders is partly in response to barriers imposed by asymmetric information. These lenders often know their borrowers personally and are thus able to overcome asymmetric information barriers faced by more formal lenders who will not know the borrowers personally or have reliable credit records and income statements for the borrowers.

[10] Stiglitz, Joseph E. and Weiss, Andrew, 1981. "Credit Rationing in Markets with Imperfect Information." *The Amercian Economic Review*. 71(3): 393-410.

[11] The Economist. August 9, 2003a. "Brazilian Banks – Better ways to go bust," 60.

[12] Caprio, Gerard Jr. and Honohan, Patrick. 1991. *Excess Liquidity and Monetary Overhangs*. Policy Research Working Paper 796, Financial Policy and Systems, Country Economics Department. Washington, DC: The World Bank, 3.

Since market imperfections in LDCs are pervasive and may even arise naturally, LDC credit markets are delivering a sub-optimal allocation of funds – money sits with the bank in liquid assets rather than going to creditworthy borrowers who can put the money to more productive use. If market imperfections can be identified, then there is a sound basis for donor or government interventions that remedy these market failures and create a more efficient allocation of capital.

Additionality

Loan guarantees should be designed to stimulate new private investment rather than subsidize existing sources of capital. If a guaranteed loan would have been made regardless of the guarantee, the guarantee may simply reflect a subsidy to the lender and it does not stimulate any additional lending. The aggregate amount of lending with or without the guarantee is the same. "Additionality" arises when a loan is made that would not have otherwise been made but for the guarantee. If additionality is achieved then the aggregate amount of lending is increased and this can promote economic growth. So, efforts should be made to ensure loan guarantees result in additional lending.

Moral Hazard

Moral hazard arises when the presence of a guarantee induces reckless conduct by the guaranteed lender or borrower. Any guarantee should provide optimal incentives for the guaranteed lender and the borrower to act responsibly. With respect to the borrower, this means they must have incentives to operate productively and repay the loan. With respect to the lender, they must have incentives to carefully screen potential borrowers to make sure they are likely to repay the loan. Lenders also should have incentives to monitor each borrower's activities while the loan remains outstanding.

A complete guarantee of indebtedness can induce substantial moral hazard on the part of the lender and the borrower. The lender with a 100% guarantee has no incentive to monitor the borrower's activity or conduct due diligence on the borrower because it can rely entirely on the guarantor to get repaid (the guarantor is always a better credit risk than the borrower). The borrower might also be more inclined to default on a loan if it knows the bank will not care about a default due to the third-party guarantee. Such borrowers may become emboldened to take on riskier activities because of the lender's lack of oversight.

Numerous 100% or near 100% government guarantee schemes have resulted in excessive defaults, and the costs arising from such excessive defaults are ultimately borne by taxpayers.[13] This phenomenon is hardly new. As far back as the 19th century, complete government guarantees were introduced to stimulate private financing for railroad construction in the United States. The government guarantees of bonds issued by railroad promoters resulted in reckless conduct by borrowers, lack of oversight and diligence by bondholders, and a huge bill for the taxpayers due to a large number of defaults.[14] The guarantees weakened the incentive for bondholders to monitor the activities of the railroad promoters who were ostensibly using the proceeds from the bonds to pay for the construction costs associated with building new railroad lines. The promoters, recognizing the lack of scrutiny over their activities, diverted resources by negotiating sweetheart deals with affiliated construction contractors and effectively channeled vast sums to their own accounts. They also put money to unproductive use, building railway lines where there was not sufficient traffic to generate adequate revenues for servicing the debt. In many instances there were defaults on the bonds but the promoters made a fortune on the construction contracts, and the taxpayers were the ones who got stuck paying the bondholders.[15]

Sustainability – Demonstration Effect

Government or donor interventions in the form of loan guarantees that produce additional lending and minimize moral hazard can create a more efficient and productive allocation of capital. If loan guarantees also spark sustained lending to new sectors or new borrowers they can serve as a catalyst for the development of local credit markets. Partial loan guarantees can demonstrate to banks the profitability of lending to new types of borrowers while also encouraging banks to conduct sound due diligence and prudent oversight. The experience of profitable lending, coupled with enhanced internal risk-assessment and monitoring capabilities, can give banks a powerful economic incentive to continue making loans to new sectors and borrowers, regardless of the presence of guarantees. Since banks often behave in a herd-like manner, other banks may follow the lead of the original bank that lends to a traditionally

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[13] For a general discussion of past credit guarantee programs in LDCs, see Levistky, J. 1997. "Credit Guarantee Schemes for SMEs – an international review." *Small Enterprise Development*. 8(2), 4-17; and Meyer, R.L. and Nagarajan, G. 1996. *Evaluating Credit Guarantee Programs in Developing Countries*, Economics and Sociology Occasional Paper No. 2322. Columbus: Ohio State University.

[14] Eichengreen, Barry. 1996. "Financing Infrastructure in Developing Countries: Lessons from the Railway Age." In Mody, Ashoka, ed. 1996. *Infrastructure Delivery: Private Initiative and the Public Good.* Washington, DC: The World Bank.

[15] Ibid., 120.

credit-marginalized sector, resulting in the transformation of local credit markets and accelerated economic growth.

Overview of Loan Guarantee Programs

A wide variety of loan guarantee programs have been implemented around the world with different objectives. The objectives of guarantee schemes sometimes vary or are unclear.[16] Advancing economic growth is often an objective, but other considerations lead to additional objectives, such as augmenting credit to a politically influential sector or aiding groups that have traditionally been victims of discrimination. Many guarantee schemes suffered from moral hazard, a lack of additionality or excessive administrative costs and claims that rendered the guarantee program unsustainable.[17]

Features of USAID'S Development Credit Authority

USAID's Development Credit Authority (DCA) - the authority under which USAID can offer partial loan guarantees to private sector lenders - was established to help USAID finance development projects in a cost-effective manner and to foster private sector lending in LDCs.[18]

In designing a guarantee program there are many choices such as the degree of guarantee coverage, the targeted beneficiaries and sectors for the guarantees, the fees, and the links between the guarantee and other interventions. The objectives and resources of a guarantor will largely determine how these choices are made. The following discussion presents many of the choices USAID has made with respect to the structure of its DCA guarantees.[19]

Targeted Sectors

DCA partially guaranteed loans generally range in size from the local currency equivalent of $1 million to $20 million and have been made across a wide-range of sectors, including agriculture, energy, infrastructure, housing and health. Small and medium enterprises and microentreprenuers have also been frequent beneficiaries of DCA guarantees.

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[16] Meyer and Nagarajan 1996, 5.

[17] Ibid., 7, 9 and 11.

[18] Partial loan guarantees are cost-effective because they leverage private sector capital and resources. Also, under the U.S. Federal Credit Reform Act of 1990 the budget cost for a federal agency issuing a loan guarantee is based on the anticipated payout under the loan guarantee rather than the full contingent liability of the U.S Government. As a result, the budget cost for a partial loan guarantee for a project in an LDC generally ranges from 2% to 9% of the amount of the loan.

[19] This guarantee program is still very new and a detailed study of the impact of these guarantees is warranted once the program has a longer operating history.

Local Currency

DCA guarantees are primarily offered for local currency lending by private sector banks and non-bank financial institutions in LDCs. By offering guarantees of loans in domestic currencies USAID seeks to redirect some of the abundant capital held by banks in liquid assets towards productive private sector firms. Guarantees of local currency lending also minimize exchange rate risk. If a loan is denominated in the local currency and the borrower earns revenues in local currency, a significant depreciation in the local currency will not, by itself, impair the ability of the borrower to repay the loan.[20] Guarantees of dollar-denominated loans are generally prohibited unless the borrowers earn revenue in dollars rather than the local currency. Over the past decade the failure to minimize exchange rate risk has produced dramatic losses for international investors and sparked numerous economic crises in LDCs.

Market Imperfections and Additionality

Prior to USAID's internal approval of a DCA guarantee, the USAID internal operating unit requesting the guarantee must demonstrate to the satisfaction of an internal Credit Review Board that the guarantee seeks to address a market imperfection and will achieve additionality. Additionality is difficult to prove because it involves a counterfactual claim (if the guarantee was never offered, the loan would not have been made). DCA projects often involve loans to a sector (i.e., housing, energy or health) or a class of borrowers (i.e., small businesses or farmers) to which the lender has not previously extended credit, and this suggests that the lending is additional. In many instances the guarantees cover a portfolio of loans for the new sector or class of borrowers, and the guarantee helps induce the bank to initiate the new portfolio of loans. To ensure additionality modest fees are also charged to guaranteed lenders – presumably lenders would be reluctant to pay such fees if they are otherwise willing to make the same loan without a guarantee.

Moral Hazard and Capacity-Building

Choosing the level of guarantee coverage largely represents a trade-off between minimizing moral hazard and maximizing the ability of the guarantee to induce additional lending. Increasing the percentage of losses that are cov-

[20] An international guarantor still undertakes exchange rate risk on local currency loans with respect to the appreciation of the local currency against the U.S. Dollar, Euro or other relevant foreign currency. If the local currency appreciates against the U.S. Dollar then any default will result in a larger claim on USAID since USAID will use U.S. Dollars to purchase local currency to pay claims. To cap this risk USAID imposes a ceiling on the amount of U.S. Dollars it will use to purchase local currency to pay claims.

ered by the guarantee will reduce the risk-perception of the lender and thereby improve the prospects for additional lending, but it can also raise the likelihood of reckless conduct because the guarantor will bear most of the losses from defaults. Due to strong concerns about moral hazard, the level of coverage under USAID partial guarantees is limited to 50% of a lender's actual losses arising from a default (this is the defaulted amount less post-default recoveries from collateral or other assets of the borrower).

The terms of the USAID guarantee agreements require that the guaranteed lenders exercise reasonable collection efforts before making a claim under the guarantee.[21] The guarantee agreement often requires that the guaranteed lender write-off the loan or make a specific provision for possible loan losses before submitting a claim. At the point when actual losses are reflected on the bank's balance sheet, USAID is obligated to pay a claim and effectively share 50% of such losses with the lender. After receiving payment on a claim, a guaranteed lender is required to continue to pursue reasonable collection efforts and then reimburse USAID 50% of any recoveries, net of legal and administrative costs. The terms of the guarantee agreement ensure that the ultimate losses to USAID will never exceed the losses actually incurred by the guaranteed lender after taking into account any post-claim recoveries obtained from the borrower.

The 50% guarantee of actual losses ensures that the lender has equal or greater incentives than USAID to avoid borrower defaults and to exercise all reasonable measures to recover funds from the borrower following a default. Consequently, guaranteed lenders are likely to conduct sound due diligence on the borrower and to carefully monitor the guaranteed loans. This approach allows USAID to leverage the operational resources of the local lender as well as its financial resources. Although USAID conducts its own risk assessment to determine the level of internal reserves it needs to set aside to cover claims, it relies substantially on the complementary due diligence and ongoing loan portfolio monitoring of the local guaranteed lender. The limited internal costs to USAID for due diligence and administration of the guarantee are not passed on

[21] "Reasonable collection efforts" vary from country to country. Generally reasonable collection efforts do not require the guaranteed lender to complete judicial proceedings and obtain a final judgment against a defaulting borrower before submitting a claim under the guarantee agreement.

to the guaranteed lender. By leveraging the resources of USAID's private sector partner, the overall transaction costs are lowered.[22]

Technical Assistance and Policy Reform

USAID guarantees are often implemented after technical assistance or policy reform efforts have been introduced to help overcome market imperfections. Some technical assistance efforts have focused on overcoming the market imperfections that impede lending into creditworthy sectors by training local banks in understanding new market segments and target borrowers. Banker training also seeks to familiarize banks with more rigorous cash-flow analysis techniques and more advanced risk assessment, management, and loan monitoring techniques. The combination of banker training and a USAID guarantee is often used to facilitate lending to small enterprises. Technical assistance is also used to improve the financial record-keeping of businesses so that lenders can more readily understand their activities and assess the credit risk of lending to such businesses. The combination of USAID funded technical advisors working with firms to improve their financial record-keeping and a USAID guarantee on a portfolio of loans by a bank to these businesses can induce lending to borrowers that were previously denied credit.

USAID policy reform initiatives often try to establish a legal and regulatory environment that is conducive to greater private sector activity and increased domestic lending. Partial guarantees are frequently offered as a complement to these initiatives. For example, in Egypt USAID has worked closely with municipalities to allow for greater private sector participation in the delivery of infrastructure services. USAID helped enact legal reforms to allow utilities to charge reasonable user-fees for municipal infrastructure services and to hire private sector companies to deliver infrastructure services. To complement these reforms, USAID has recently offered partial guarantees on commercial loans to private companies hired by utilities to provide infrastructure services such as wastewater removal and repair of existing water pipes. The availability of DCA-backed loans can demonstrate that tariff reforms and laws and regulations that allow for private sector delivery of infrastructure services can yield a

[22] Many guarantee schemes have suffered because costs were too high from the duplication of efforts –both guarantor and lender performed substantial diligence and screening of borrowers. See Levitsky 1997. USAID avoids this problem by absorbing its own diligence and administrative costs and relying on the lender for additional diligence and monitoring efforts. It is generally much cheaper and more efficient for the domestic lender to perform diligence than a foreign guarantor. Foreign guarantors will confront greater asymmetric information because of their lack of familiarity with local business conditions and the quality of potential borrowers. Greater distance from borrowers also necessitates much higher costs for loan monitoring and diligence efforts.

lower-cost and more effective provision of water and sanitation services. Such positive results provide further impetus for municipalities to continue on the reform path.

Fees

Almost all guarantee programs have imposed fees on the guaranteed lenders. If guarantee programs charge high fees they will reduce their ability to encourage banks to enter new sectors or extend loans to new types of borrowers. The cost of the fee coupled with the riskiness of the new form of lending may be too much for a lender to endure. However, if a guarantee program charges very low fees (or no fees at all) the program may have difficulty accumulating enough fees to keep it operational. USAID charges an upfront commitment fee and an annual utilization fee for its DCA guarantees. These fees are set below a cost-recovery level, so in the aggregate USAID expects to pay claims in excess of the fees it accumulates. Annual appropriations from the U.S. Congress are used to cover this expected shortfall as well as the administrative costs associated with the guarantee program.

Impact of DCA Guarantees and Array of DCA Products

Impact of partial guarantees on the terms and conditions of the loan

Generally a partial loan guarantee reduces a lender's perceived level of risk for new types of loans. The guarantee lowers the lender's potential loss from defaults. Also, guarantees from a triple-A rated guarantor enable banks to lower the reserves they need to set aside for a loan, and this allows them to earn a greater return on equity. Lenders may agree to different terms and conditions for a loan due to the presence of a partial guarantee. The provision of the guarantee can reduce the lender's collateral requirements and thereby enable businesses or entrepreneurs that lack substantial collateral to obtain loans. The guarantee can also cause the lender to offer a longer repayment period for the loan which enables borrowers to make costly 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.

DCA Products

DCA guarantees are generally offered through four different products – *loan guarantees, bond guarantees, loan portfolio guarantees and portable commitment guarantees*.

Loan Guarantees cover 50% of the risk on an individual loan from a lender to a pre-determined borrower. The purpose of the loan and the use of proceeds are set forth in both the loan guarantee agreement between USAID and the lender and a separate agreement between USAID and the borrower.

Bond guarantees cover 50% of the risk to bondholders. The guarantee agreement is generally entered into between USAID and the trustee or agent for the bondholders. The trustee is responsible for pursing collections on behalf of the bondholders following a default. The identity of the borrower (often called the bond "issuer") is known in advance, and USAID will have an agreement with the bond issuer setting forth the permitted use of proceeds.

Loan Portfolio Guarantees cover 50% of the risk to a lender from a portfolio of loans that it plans to make to "eligible borrowers" who satisfy certain predetermined criteria. The identity of the borrowers is not known at the time the loan guarantee agreement is signed. For example, USAID may guarantee a portfolio of loans by a bank to small businesses operating in a certain region to which the lender has not previously extended credit.

The *Portable Commitment Guarantee* is a commitment letter between USAID and a prospective borrower. The letter indicates the terms upon which USAID will guarantee a loan to such borrower. Often the prospective borrower has been unable to engage banks in serious discussions about a loan, and the letter helps them "open the door" to the banks and get a full hearing for their business plan. Once the prospective borrower is able to find a committed lender, USAID enters into a guarantee agreement with the lender.

Potential Impact of Loan Guarantees on Key Sectors

Several types of businesses and sectors in LDCs that can play a significant role in economic growth or poverty reduction but have traditionally suffered from a lack of access to credit are small and medium enterprises (SMEs), microenterprises, housing and infrastructure. They can each benefit immeasurably from more robust local credit markets. By reducing risk-perception, lowering collateral requirements, and extending loan repayment periods, partial loan guarantees have the potential to increase the amount of credit provided for SMEs, microenterprises, housing and infrastructure. A detailed description of the potential impact of partial loan guarantees on each of these four groups is presented on the following pages.

Small and Medium Enterprises

A primary engine for growth and a major source of employment are small and medium size enterprises (SMEs). Despite the immense role of the SME sector in the overall economy of LDCs, the growth of this sector is severely curtailed by a lack of access to finance.

The availability of credit has been identified in many business surveys as the most important factor determining whether SMEs survive and prosper.[23] The ability to borrow allows SMEs to make productive investments and purchase new technology that will enable them to grow their businesses.[24] Unlike large companies, SMEs in developing countries only finance a modest portion of their investment through debt financing and they are forced to rely on retained earnings and financial support from family and friends to launch or grow their business. Even when debt financing is available to SMEs, the maturities of the loans are often too short to allow for SMEs to finance sizable investments that take years to repay.

There are several reasons for the SME financing deficit. From the perspective of banks and other financial intermediaries, the main barriers to SME lending are high risk perception, asymmetric information, lack of collateral and high administrative costs.[25] High risk perception with SMEs stems from a number of factors such as lack of demonstrated profits over a long term, inadequate collateral and traditional prejudices based on race, ethnicity or geography. Asymmetric information is extensive because SMEs generally do not have a well-documented credit history with years of audited financial statements and reliable financial reporting.[26] High administrative costs arise because banks often lack experience in servicing SME borrowers, and due to the small amounts of each loan the aggregate costs of information-gathering, due diligence, loan processing, and ongoing monitoring are much higher per dollar loaned than for loans to large corporate borrowers.

As a result of asymmetric information and high risk perceptions, banks primarily conduct collateral-based lending rather than cash-flow analysis when

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[23] United Nations Conference on Trade and Development. 2001. "Improving the Competitiveness of SMEs in Developing Countries: The Role of Finance to Enhance Enterprise Development." UNCTAD/ITE/TEB/Misc.3. Geneva, 3.

[24] Ibid., 3.

[25] Green, Anke. 2003. *Credit Guarantee Schemes for Small Enterprises: An Effective Instrument to Promote Private Sector-Led Growth?* SME Technical Working Paper No. 10. Vienna: United Nations Industrial Development Organization.

[26] Many prospective borrowers maintain multiple sets of books and opaque accounting standards.

working with SME borrowers. Collateral requirements often exceed 150% of the value of the loan – this is an insurmountable threshold for many potential borrowers.[27] This problem is magnified by the fact that many small business owners, entrepreneurs or farmers in LDCs are unable to pledge their home or land as collateral because they lack valid legal title to it.[28] In Africa, "less than 10% of the continent's land is formally owned, and barely one African in ten lives in a house with title deeds."[29] In contrast, in developed countries the primary source of collateral offered to obtain a start-up loan for a new business is a pledge on the business owner's home and land.

Partial loan guarantees can help overcome some of the barriers to credit for SMEs. The primary tangible impact of a partial loan guarantee is a lowering of the collateral requirement, and this alone can enable more SME borrowers to gain access to credit. After repaying a partially guaranteed loan SMEs will have positive credit histories. Such credit histories will help reduce asymmetric information and can reduce the high-risk perception of banks. Bank relationships with clients "are a principal channel for acquiring information" and a borrower's "improved cash flow probably signals a healthier balance sheet and thus also serves to trigger increased lending and perhaps a lower cost of funds [for the borrower]."[30]

Partial loan guarantees can also encourage banks to provide longer term loans. The longer repayment period allows SMEs to make larger investments in new equipment and technology that can boost productivity and enable businesses to expand.

Micro-Enterprises

Over the past 20 years microfinance institutions (MFIs) have proliferated throughout developing countries, extending credit to over 50 million poor people and helping lift many of them out of poverty. MFIs generally provide small loans and other financial services to poor, self-employed entrepreneurs. Frequently microfinance loans serve as working capital and no formal collateral is required from borrowers, but collateral substitutes such as group guarantees

[27] Green 2003, 12 and 13 and Leeds, Roger S. 2003. *Financing Small Enterprises in Developing Nations*. New York: Transnational Publishers, Inc., xvii.
[28] For a discussion of the importance of land-titling in LDCs as a way to unlock "dead capital" and provide economic opportunity for the poor, see de Soto, Hernando. 2000. *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else*. New York: Basic Books.
[29] The Economist. January 17, 2004. "Survey: How to make Africa smile -, a survey of sub-Saharan Africa," Special Section 6.
[30] Caprio and Honohan 1991, 5.

are prevalent. Default rates on microenterprise loans have been very low, and the profitability of MFIs has dispelled the myth that the poor are bad credit risks.

The microfinance industry has been growing at an estimated rate of 20% per year. Nevertheless, the demand for microfinance loans far exceeds the capacity of MFIs to reach all potential borrowers. Most MFIs were created as non-profit organizations and they have relied heavily on donor funding. The available supply of donor funding to finance continued growth in the microfinance sector is limited, and MFIs have been unable to leverage substantial debt or equity from non-donor sources. If MFIs are to maintain continued growth, they will need to access funding from commercial sources, such as local commercial banks and bond markets. The process of "commercialization" of MFIs has proven challenging and hardly any of the over 2000 MFIs have achieved sustained financing from commercial sources.

Local commercial banks and other private investors are reluctant to finance MFIs despite their successful track-record and the low default rates on their loans. Banks are reluctant to lend to MFIs because of high risk-perceptions, lack of collateral, and a lack of demonstrated profits over an extended period of time. By lowering risk-perceptions, partial loan guarantees can help induce commercial lenders to extend credit to MFIs for the first time. If these loans prove profitable, private lenders will be more inclined to fund MFIs on an ongoing basis. The repayment record of the MFIs will constitute valuable credit history, and commercial lenders will also learn more about assessing risk and conducting due diligence on MFIs through the process of making loans.

A number of recent USAID partial guarantees have created initial linkages between top-tier MFIs and private lenders, including the first bond-offering by an MFI in Peru and the first commercial bank loans to several prominent MFIs in Morocco, Colombia, Uganda and South Africa. In many instances USAID grant-funded technical assistance helped these MFIs improve their transparency and financial record-keeping, making it easier for commercial banks to assess the risk from extending credit to them. The combination of technical assistance and partial guarantees enabled these MFIs to tap commercial sources of credit for the first time.

Housing

Housing finance plays a crucial role in the economies of developed countries. Mortgage loans constitute the most sizable form of credit for most individuals, and a large percentage of adults in developed countries have home mortgages. In the U.S. alone, the mortgage market is several trillion dollars,

exceeding the size of the markets for U.S. corporate bonds and U.S. Government bonds.[31] The widespread availability of housing finance fuels economic growth and spurs the construction of new homes which creates jobs. Housing finance provides important non-economic benefits as well, such as greater social cohesion and strengthened communities as a result of increased homeownership.

In LDCs the demand for housing finance is substantial, but most individuals cannot obtain a loan for the purchase of a home.[32] There is widespread credit rationing. Banks often ration housing credit by raising down payments to very high levels (40% is often the norm in transition economies),[33] thereby excluding a high percentage of low and middle-income individuals from obtaining a mortgage loan. Many potential borrowers do not have the funds for the minimum down payment. Two of the primary reasons why banks in LDCs ration housing credit are:

i) banks have little confidence that they can sell a house following a borrower's default; and
ii) banks do not have reasonable assurances of a borrower's level of future annual income, so they do not have a good sense of the likelihood of a default.[34]

Addressing the root causes for the scarcity of housing finance requires legal and regulatory reform that allows lenders to easily enforce contracts and foreclose on collateral in a timely and cost-effective manner. In addition, land-titling is needed so that more potential borrowers have valid legal title to their land and can use it as collateral for home improvement loans.[35] Asymmetric information poses another hurdle to housing credit because it is difficult for lenders in LDCs to estimate a borrower's income due to the large informal sector and the lack of credit bureaus.[36] In the U.S., mortgage lenders scrutinize W-2 annual wage statements, income tax returns and detailed credit reports to assess a borrower's income and likelihood of repayment. In contrast, lenders in LDCs lack reliable information about a borrower's annual income and credit history.

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[31] Jaffee, Dwight and Renaud, Bertrand. 1996. *Strategies to Develop Mortgage Markets in Transition Economies.* World Bank Policy Research Working Paper 1697. Washington, DC, 3.
[32] Ibid., 9.
[33] Buckley, et al. 2003. *Comparing Mortgage Credit Risk Policies: And Options-Based Approach.* World Bank Policy Research Working Paper 3047. Washington, DC, 1.
[34] Jaffee and Renaud 1996 and Buckley, et al 2003.
[35] De Soto 2003.
[36] Jaffee and Renaud 1996, 9.

Regardless of the pace of reforms to address the underlying causes for the lack of housing credit, lenders will need to overcome the high risk-perception they associate with housing loans in order for increased credit to flow into the housing sector. Partial loan guarantees can help reduce this risk-perception and expand the provision of credit for housing finance. Similar to high collateral requirements for SME borrowers, high down payments of 40% or more effectively exclude creditworthy borrowers from access to finance for housing loans. A partial loan guarantee can lead to a reduced down payment requirement, thereby enabling credit to flow to new borrowers.

There is high demand for home improvement loans among poor people in developing countries because they often build incrementally rather than purchase new homes. Lenders have been reluctant to extend credit to the poor for home improvement loans. Partial guarantees can reduce barriers to entry for this new type of lending as well. If recipients of mortgage loans or home improvement loans succeed in making monthly loan repayments they will have developed valuable credit histories with their lenders. This makes it easier for them to get loans in the future.

Another important potential benefit from partial guarantees of housing loans is a lengthened repayment period. Borrowers often need long periods of time to repay housing loans and prefer loans with a long repayment period. The 30-year mortgage loan is rare outside the U.S., and in most developing countries mortgage loans have a very short repayment period (usually 5 years or less). The situation in many LDCs resembles the condition of the housing market in the U.S. in the 1930s – down payments were 40% or higher and mortgage loans were for 5 years or less. By inducing banks to offer longer repayment periods, partial loan guarantees can enable more borrowers to have sufficient time to repay housing loans.

For example, USAID's recent experience with a partial guarantee in Romania resulted in an extended repayment period for mortgage loans. USAID helped establish the first non-bank mortgage lender in Romania, Domenia Credit.[37] USAID covered some of the start-up and operational costs for Domenia Credit while also working on legislative and policy reforms to improve foreclosure and land registration procedures. In addition, USAID provided a partial guarantee of a 10-year loan to Domenia Credit (long-term by Romanian standards) and this has enabled them to establish a sizable portfolio of mortgage loans ranging from 5 to 10 years.

[37] Domenia Credit was created by the Romanian American Enterprise Fund (RAEF). RAEF was established with a grant from USAID. In addition to RAEF, there are several international investors that have made equity investments in Domenia Credit.

The housing finance experience of the U.S. suggests that government guarantees can be particularly beneficial. The U.S. 30-year mortgage market was largely created by credit enhancements in the form of U.S. Government guarantees. Lenders were not initially willing to make 30-year loans, but guarantees from the Federal Housing Association (which were backed by the full faith and credit of the U.S. Government) helped entice lenders into extending 30-year credit. Over time, the U.S. Government guarantee has been withdrawn for most 30-year mortgages but the demand from lenders and capital market investors for such 30-year mortgages has continued and expanded, and a highly liquid secondary market has developed.[38] This has helped drive down the cost of mortgages for millions of homeowners.

Infrastructure

In countries that lack adequate electric power, telecommunications, roads, railways, water supply, sanitation and sewerage, it is much harder for private enterprises to prosper. The costs of producing and transporting goods or delivering services rise substantially due to deficient infrastructure. These increased costs make companies less competitive and efficient. They also result in higher costs to consumers which in turn decreases demand and is harmful for growth. Enormous investments in the infrastructure of LDCs are needed. One recent study estimated the demand for new investments in infrastructure in developing countries between 2005 and 2010 will be approximately $233 billion and maintenance requirements for existing infrastructure during this period will be roughly $231 billion.[39]

The deficient infrastructure in LDCs coupled with the rapid growth of the urban population makes the need for infrastructure improvements all the more pressing. Traditionally, national governments had primary responsibility for infrastructure, but increasingly this responsibility is being transferred to municipalities. Municipalities cannot meet these vast infrastructure needs solely from expenditure of their limited funds – they need private sector participation in the financing, building and maintenance of infrastructure projects and the delivery of infrastructure services. If municipalities charge user-fees on a cost-recovery basis for infrastructure services (such as electricity, water, sanitation, or the use of roads) they can generate a revenue stream that will allow them to repay loans that help finance their infrastructure investments. The introduction of user-fees that are set on a cost-recovery basis can attract sustainable private sector financing.

[38] See generally Lea, Michael. 1996. "Innovation and the Cost of Mortgage Credit: A Historical Perspective." *Housing Policy Debate*. 7(1): 147-174.
[39] Fay, Marianne and Yepes, Tito. 2003. *Investing in Infrastructure: What is needed from 2000 to 2010?* World Bank Policy Research Working Paper 3102. Washington, DC.

Infrastructure finance generally requires long-term lending, preferably in the local currency to avoid currency depreciation risk. Unfortunately, the local capital markets in most LDCs generally do not offer long-term lending and many municipalities or private sector developers of infrastructure are unable to obtain any financing from local credit markets. For example, a report on infrastructure in India noted that "a true local credit market is essential for India meeting its infrastructure investment objectives" but local credit markets are currently very limited and can only supply a small amount of the billions in public investment which will be needed in coming years.[40]

The absence of long-term lending in local currency creates a huge financing gap for infrastructure in LDCs. The bond market generally offers longer-term financing than the bank market because bondholders (primarily pension funds and insurance companies) have longer-term liabilities which they seek to match with assets, such as bonds, that generate a steady stream of income over a longer-period of time. These bondholders are often required by law to hold a large percentage of their assets in safe bonds or other securities that have received an investment grade rating from a reputable rating agency. A major challenge for infrastructure finance in LDCs is developing projects that can receive investment-grade ratings and thus take advantage of the full range of potential bond investors.

Partial guarantees provide a credit enhancement to a bond offering that can result in a higher credit rating from the rating agency.[41] The higher rating helps reduce the risk-perception of potential bondholders and enables a wider class of investors to purchase the bonds. The provision of the partial guarantee can also spur the bond investors to agree to a longer term for repayment. Longer repayment schedules allow for bond repayments to be more consistent with the time-horizon for generating revenues from the underlying infrastructure investment.

For example, in a recent bond-offering in India to finance municipal infrastructure investments in water and sanitation systems, the USAID 50% guarantee, together with additional credit enhancements from the national and state governments, helped produce an investment-grade rating and a 15-year maturity on the bonds. This is an unusually long repayment period for an LDC infrastructure project and exceeded the term of previous municipal bonds in India by several years. The lengthened repayment period provides significant time for user-fees to accumulate that can service the debt. The partial guarantee

[40] Peterson, George. 2000. *Building Local Credit Systems.* UNDP/UNCHS/World Bank, 2, citing National Council of applied Economic Research. 1997. *The India Infrastructure Report*. New Delhi.

[41] The impact of a partial guarantee on the credit rating for a bond will depend on the nature of the guarantee. Guarantees that cover some "first loss" risk, such as the initial default on an interest payment under a bond, can provide a greater boost to the overall credit rating.

also complemented USAID technical assistance and policy reform efforts that laid the groundwork for the bond offering by improving municipal accounting standards and allowing for cost-recovery tariffs.

Conclusion

The increased use of partial loan guarantees by USAID and other donors largely reflects the recognition that harnessing the energy and resources of the private sector is essential for development and that robust domestic credit markets can fuel sustained economic growth.

Partial loan guarantees can be a mechanism for unlocking some of the liquidity within the banking system in LDCs and allocating this capital to productive enterprises. Loan guarantees reduce the high risk-perception of banks and can lead to lower collateral requirements or longer repayment periods. This facilitates the provision of credit to new sectors and/or new types of borrowers.

There are many root causes for the lack of credit in LDCs, and loan guarantees should not be viewed as a substitute for other efforts such as legal and regulatory reform that address some of these root causes. Rather, loan guarantees are an additional tool for building robust credit markets, and they will prove more effective when implemented together with technical assistance or policy reform that alleviates barriers to credit. In order to spur growth, loan guarantee programs should seek to induce additional lending while also minimizing moral hazard. Guarantees that demonstrate the profitability of new forms of lending and spark sustained lending to new sectors or borrowers can serve as a catalyst for the development of local credit markets.

Perhaps the most significant potential contribution of partial loan guarantees to economic growth is inducing financial innovation and new types of financings that are profitable and easily replicated. Partial guarantees can contribute to innovations in LDC financial markets by helping develop non-sovereign bond markets that provide long-term financing for infrastructure and housing. Partial guarantees can also help introduce commercial lenders to the microfinance sector and stimulate heightened levels of credit to SMEs. In more mature LDC financial markets, there are opportunities for partial guarantees to help introduce new financial technologies such as secondary debt markets. Guarantees can also promote structured finance techniques such as securitizations or credit default swaps that lower the cost of capital and diversify risk. If partial guarantees help introduce some of these innovations and trigger the widespread use of new types of lending, they can contribute immensely to the transformation of credit markets in LDCs.

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