This Focus Note looks at recent experience with guarantees of commercial loans to microfinance institutions (MFIs). Such loan guarantees are a form of insurance that covers a lender—typically a commercial bank—against default on its loan to an MFI. If the MFI defaults, the guarantor (that is, the issuer of the guarantee commitment) pays the bank the guaranteed portion of the loan. The MFI pays for this insurance in order to get a loan from a bank that will not lend without some additional security for payment.\(^1\) Loan guarantee structures are described in the annex.

In the microfinance industry, experimentation with loan guarantees began largely as an attempt to demonstrate to local banks that MFIs are creditworthy. In 2004, loan guarantees accounted for only about 8 percent of total foreign investment in MFIs.\(^2\) However, use of this funding instrument is growing rapidly.

This Focus Note discusses the results of a study, jointly supported by CGAP and USAID, that draws on data provided by guarantee agencies, publicly available financial reporting by MFIs, and telephone and e-mail exchanges with selected MFI managers and guarantee agency staff.

The study
- reviews the specific benefits loan guarantees are meant to produce;
- describes guarantor agencies, transaction volumes, cost structure, and guarantee mechanisms; and
- examines the results of a set of 96 loan guarantees issued by eight agencies and draws conclusions about the effectiveness of loan guarantees.

**Key Findings**

Loan guarantees can enable MFIs to get loans that are otherwise unavailable to them. The immediate benefits of guaranteed loans typically have been modest, and the cost

\(^1\) The term *loan guarantee* is used here to refer to a guarantee that backs up a loan to a single MFI from a bank or other lender. It is one subset of the broader category of *credit guarantees*. Another type of credit guarantee is the *portfolio guarantee* that protects a bank’s whole portfolio of loans to specified types of retail borrowers, such as farmers or small businesses. This Focus Note does not discuss portfolio guarantees. Bannock and Partners (1997) and the DFID studies (Billington, Bennet, and Doran 2005) provide a good overview of experience with the range of credit guarantees. Refer to the annex for a description of how loan guarantees are structured.

\(^2\) Ivatury and Abrams (2005), from a 2004 CGAP-MIX-ADA survey of microfinance foreign investors.
of the loans has been high despite substantial subsidies of the guarantors. Moreover, as competitive MFIs grow, in most markets they are finding better ways to access local funding than borrowing from local banks.

However, guarantees are effective when they are used to structure loans to MFIs under conditions more favorable than typical bank loans. Guarantors realize this potential by focusing on specialized international lenders and on the handful of markets where local commercial banks make loans to MFIs at lower interest rates than they charge to normal retail business borrowers.

Why Do Funders Use Loan Guarantees?

Why does a development agency or investor use a loan guarantee instead of the simpler alternative of making a direct loan to an MFI? Sometimes there are internal reasons—for instance, where lending is not allowed by the agency’s charter or the agency is not equipped to manage loan repayments. But most of the reasons have to do with perceived advantages for MFIs.

Facilitating access to local bank loans

The primary rationale for guaranteeing loans instead of lending directly to the MFI is to initiate access to commercial funding markets. The guarantee is meant to facilitate a loan from a bank that would not otherwise lend to the MFI, usually with the expectation that the experience will increase the bank’s appetite for future unguaranteed lending. Most, but not all, guarantors aspire to link MFIs with local banks—92 percent of the guarantees were issued to local banks. This reflects the long-term view that MFIs need to integrate into their local funding markets to achieve significant scale and that borrowing from local banks is a viable way for MFIs to achieve that integration.

Reducing risk for international lenders

A small, but increasing, number of guarantees are used to reduce risk for specialized international MFI lenders, commercial banks, and commercial investors in international MFI lending facilities. In these cases, the guarantees facilitate MFI access to large pools of international commercial capital.

Leveraging guarantors’ capital and supplementing MFIs’ collateral

Guarantors typically insure only part of the bank’s loan to the MFI, and they cite the ratio of the total loan to the guaranteed amount as a measure of how much the loan guarantee leverages the guarantor’s capital.

Facilitating a local currency loan to the MFI without exchange rate risk to the guarantor

If a foreign funder lends hard currency to a local MFI that will have to repay the loan from local currency revenues and assets, a depreciation of the local currency could expose the MFI to substantial loss. Conversely, the foreign lender would itself face the same risk if it made a local currency loan to the MFI. A guarantee structure can avoid this problem: 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 exchange risk and the guarantor or the local bank with relatively minor exchange risk in the event of default, depending on the guarantee terms.

Overcoming regulatory barriers

In a few countries, laws or regulations restrict foreign borrowing or make it more expensive. The loan guarantee facilitates a local loan without creating a foreign obligation for the MFI. Loan guarantees can also increase the MFI’s collateral so that the bank’s loan complies with banking regulations that restrict unsecured lending.
The Supply of Loan Guarantees

Most loan guarantees for MFIs have occurred since the late 1990s, although such guarantees were pioneered a decade earlier by ACCION’s Latin American Bridge Fund and by RAFAD (Recherches et Applications de Financements Alternatifs au Développement). The 2005 CGAP study (Ivatury and Abrams 2005) of 54 international funders indicated that MFIs had US$96 million of guaranteed loans as of mid-2004. The Focus Note study collected information from eight guarantor agencies on 96 transactions. These transactions provided US$59 million in guarantees that supported US$87 million in bank lending to MFIs. Ninety-one percent of the transactions were made in or after 2000, and half were still in operation at the end of 2005. The amount of loan guarantees to date is not large, but the supply is growing rapidly. At least three new guarantee facilities were launched in 2005.3

Though many development agencies and private debt and equity funds offer loan guarantees, in practice the funders that offer MFIs a mix of financing instruments issue few guarantees. Most of the guarantees are issued by organizations, or departments within agencies, that are mandated and funded specifically to provide loan guarantees (Table 1).

AFD, USAID/DCA, and KfW guarantee operations are imbedded in their respective agencies, although USAID has created a distinctive program and identity for the DCA. SUFFICE has a credit and loan guarantee program in Uganda financed by the European Union. The Latin American Bridge Fund is legally separate from but managed

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3 The Global Microfinance Facility, the GFUSA Growth Guarantees, and Global Commercial Microfinance Consortium.
by ACCION International. The DBMDF is an autonomous entity that receives substantial in-kind support from Deutsche Bank. Grameen Foundation (now GFUSA) has a recently launched fund. And finally, FIG is an autonomous cooperative founded by RAFAD for the sole purpose of issuing guarantees to member MFIs.4

Profile of MFIs That Use Loan Guarantees

Most of the loan guarantees reviewed in this study supported commercial bank loans to small, nondeposit-taking MFIs that were profitable and growing rapidly.5 Ninety-two percent of the MFIs had assets below US$25 million in the year of the guarantee transaction, and only 8 percent of these smaller MFIs took deposits.

The concentration of loan guarantees in small, nondeposit MFIs reflects the strong appetite of those MFIs for any form of funding that can support their robust growth rates, together with the fact that these MFIs do not yet have access to other commercial funding sources, such as savings, time deposits, or bonds. Larger MFIs with more than US$25 million in assets were also using loan guarantees, but more selectively.6 Over half of these larger MFIs were deposit institutions. In most cases the larger MFIs used the loan guarantee for an international loan, not a loan from a local bank.

Measuring the Impact of Guaranteed Loans to MFIs

Data from the transactions in the study shed some light on the extent to which guarantees deliver the benefits they are expected to provide.

Access to initial loans from local banks

Guarantors and MFI managers report that loan guarantees help MFIs to get loans—often the MFI’s first local loan—from banks that otherwise would not lend to them.7 In addition to the guarantee itself, guarantor agencies and their international banks provide transaction expertise and credibility that enhances the local bank’s perception of the MFI. MFI managers are uniformly positive

Table 2 Characteristics of MFIs Using Guarantees, by Size

<table>
<thead>
<tr>
<th>Assets in year of transaction (US$)</th>
<th>Distribution of MFIs (%)</th>
<th>Average annual growth (%)</th>
<th>Average return on assets (%)</th>
<th>Average client loan balance (US$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>5 million or less</td>
<td>38</td>
<td>37.8</td>
<td>4.3</td>
<td>459</td>
</tr>
<tr>
<td>5.1 million–10 million</td>
<td>23</td>
<td>58.0</td>
<td>4.3</td>
<td>416</td>
</tr>
<tr>
<td>10.1 million–25 million</td>
<td>31</td>
<td>47.7</td>
<td>5.2</td>
<td>399</td>
</tr>
<tr>
<td>More than 25 million</td>
<td>8</td>
<td>57.3</td>
<td>3.1</td>
<td>1,668</td>
</tr>
</tbody>
</table>

* 2004 figures

4 The International Finance Corporation, European Investment Bank, and European Bank for Reconstruction and Development also provide loan guarantees, but were not included in this study.
5 The study compiled transaction data from 96 loan guarantees. The analysis of MFI performance includes data only from the 71 MFIs that publish financial statements in public sources such as www.themix.org or their Web sites. The data set is large enough to support conclusions about the effectiveness of loan guarantees in strong MFIs, but the lack of financial statements from 25 percent of the 96 MFIs made it impossible to correlate loan guarantee effectiveness with MFI performance.
6 The experience of the ACCION Latin American Bridge Fund also suggests that demand for loan guarantees is concentrated in smaller, borrowing-dependent MFIs. The Latin American Bridge Fund portfolio reached its peak in 1995 and had declined steadily by 2004. One of the main reasons for this is that many of ACCION’s affiliates transformed into deposit MFIs and/or diversified their funding sources in local markets.
7 Vogel and Adams (1997) discuss the methodological problems in proving that a loan guarantee changes lender behavior. Nevertheless, MFI managers make the convincing argument that they would not pay the additional costs of the guarantee if they were able to procure the loan without it.
about these benefits of the loan guarantee transactions, regardless of the size or cost of the loan.

Most of the guaranteed loans have “retail” characteristics—that is, they have the same terms as bank loans to typical business borrowers: interest rates are higher than the prime rate that banks charge to large, low-risk borrowers, real collateral requirements are high, and loan amounts are small relative to MFI assets. This tended to be the case especially in smaller nondeposit MFIs, which did in fact have the same risk profile as a typical retail bank borrower.

Almost half of the loans reviewed in the study were for less than US$250,000 and 82 percent were less than US$1 million (Table 3).

Typically, the guaranteed loans made a relatively small contribution to the MFIs’ total assets—less than 5 percent in most of the transactions and less than 20 percent in nine out of 10. The guaranteed loans did account for a larger percentage of the MFI’s total borrowing, but hardly ever more than a quarter of it (Table 4).

Cost to the MFI

Guaranteed loans have been relatively expensive for MFIs. The guarantor agencies in the study charged annual fees that ranged from 0 percent to 4.5 percent of the guarantee amount, with an unweighted average of just over 2 percent. The MFIs paid the bank interest rate (usually a retail rate well above prime) plus the guarantee fee, making the funding more costly than the MFIs’ other sources. In a sample of 13 transactions in 11 countries, the total interest cost of the guaranteed bank loan to the MFIs was on average 5.3 percentage points higher than the MFIs’ average cost of funding liabilities (including the guaranteed loan). And all but three of these MFIs already had average funding costs well above prevailing bank funding rates.

These indicators prompt reflection about the different reasons MFIs have for using loan guarantees. For a few MFIs, the guaranteed loan was a very significant increase in total funding. One might naturally assume that access to the extra capital was the MFI’s main motive. However, most of

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8 In most developing and transition economies, real collateral or guarantees consist mainly of land and buildings, cash in bank accounts, low-risk investments, and letters of credit or guarantees from third parties of known financial strength. Thus an MFI’s portfolio of microloans is not real collateral.

9 It is important to recognize that some of the seemingly cheaper alternative funding options contained foreign exchange rate risk that was not reflected in their lower price. However, very few MFIs price or manage foreign exchange rate risk, and therefore cost assessments are difficult.

10 The MFIs’ average cost of funds were compared to a weighted composite of two commercial rate benchmarks, the local interbank lending rate for the MFI’s local borrowing and 12-month LIBOR + 5 for its foreign borrowing. By comparison, the MicroBanking Bulletin uses the local deposit rate—typically the lowest market funding rate—as a commercial funding benchmark for local and foreign borrowing.
the MFIs paid a relatively high cost for a loan that didn’t add very much to their funding structure. The primary motivation of these MFIs may often have been the promise of a long-term relationship with a local commercial bank, funding diversification, the prestige of association with an international institution, or perhaps in some cases encouragement by the guarantee agency.

**Guarantee leverage and collateral enhancement**

All guarantor agencies try to extend their capital by guaranteeing less than the full amount of the loan to the MFI and usually have some target ratio for the percentage of a loan they want to guarantee. This policy leaves the bank with an incentive to collect the loan. In practice, the loan-to-guarantee ratio appears to be driven by the circumstances of each deal, and most guarantors have made deals both above and below their target ratios. The combined value of the 96 guarantees in the study was US$58.7 million. Collectively these transactions secured US$87 million in loans to MFIs, for a consolidated loan-to-guarantee ratio of 1.5. The average of the ratios in individual transactions was 2.0, reflecting higher ratios in the smaller transactions.

Banks did lend more than the guarantee amount. But the loan-to-guarantee ratio is sometimes misinterpreted as indicating that the bank is willing to take the risk of lending more than the guarantee without other collateral. In fact this does not appear to happen very often. For example, a loan-to-guarantee ratio of 1.5 usually does not mean that the bank has made a loan that is only two-thirds secured with real collateral.

The loan guarantees supplemented the MFI’s total collateral package, but the MFI typically had to pledge other real assets to cover the full loan amount. The MFIs report that most banks required “real” guarantees (land, cash, securities, or letters of credit) for at least 100 percent of the unguaranteed loan value and that this remains a considerable barrier to using bank loans of any significant size. 11

Thus, measuring the impact of the guarantee on the initial loan calls for some care. Guarantees do add value in that the MFI gets a loan that it could not have otherwise. But the loan-to-guarantee ratio is a problematic measure of leverage because it tells us nothing about the amount of real collateral the MFI had to pledge over and above the guarantee. Theoretically, it would make more sense to measure leverage by some combination of (1) the reduction in the risk component of the interest rate and/or (2) increase in the portion of the loan that is not covered by other real collateral. However, the necessary information was not available for this study, despite the importance of these characteristics of the transactions.

**Local currency loans for MFIs**

Ninety-two percent of foreign debt is issued to MFIs in hard currency. 12 But most MFIs lend in local currency, so they have to rely on local currency revenues and assets to repay a hard currency loan. If the local currency’s exchange rate suffers a serious depreciation, the borrowing MFI may have to use much more local currency than it budgeted to pay off the loan, sustaining heavy losses in the process. MFIs seldom have access to adequate hedging mechanisms against such exchange risk. 13

The foreign lender can avoid imposing exchange risk on the MFI by denominating the loan in local currency, but this shifts the exchange risk to the lender, who may receive a repayment that is much less than the hard-currency value of the amount lent.

Guaranteeing loans by local banks in local currency avoids this kind of exchange risk for both the MFI and the foreign source: not surprisingly,

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11 In contrast to this general pattern, AFD reports that when it issues guarantees—seven of which were included in this study—it makes sure that the bank does not require additional collateral.
82 percent of the guaranteed loans were issued in local currency.

**Overcoming legal or regulatory barriers**

In a few countries, regulations restrict foreign borrowing or make it more expensive. India and Morocco, for example, restrict foreign borrowing by nonprofit organizations. The loan guarantees to MFIs in these countries avoided these restrictions by facilitating a local loan.

Loan guarantees can also help to resolve the more pervasive issue of regulations that limit unsecured lending by banks. For instance, in most cases regulators will recognize an MFI’s real estate but not its loan portfolio as qualifying collateral. In these situations, the guarantee may be needed to bring the loan to the MFI into compliance with banking regulations.

**Do MFIs Obtain Subsequent Unguaranteed Loans from Local Banks?**

Most guarantors consider loan guarantees a success if MFIs are eventually able to borrow from their local banks without a loan guarantee. The results are mixed, and they illuminate two misconceptions imbedded in the idea that MFIs should necessarily graduate to unguaranteed borrowing. First, in commercial financial markets, lenders use guarantees as a risk management tool and may decide to do so indefinitely if guarantees are more efficient than other methods. Likewise, when guarantees are used to overcome regulatory barriers they will likely be necessary for future transactions as well. Second, MFIs often find better sources of commercial funding than borrowing from local banks.

Some of the MFIs did borrow subsequently without a guarantee, and they credit the earlier loan guarantee transaction with facilitating their relationship with the lending bank. However, some MFIs chose not to increase their borrowing from local banks. Over time, the MFIs in the study tended to fund their growth from other sources, except in markets where banks deliberately establish a business line of lending to MFIs in better-than-retail conditions.

Most of the MFIs that are maturing in competitive markets are growing with commercial funding sources that offer better conditions (lower cost, longer term, lower collateral requirements) than local retail loans. Even among the MFIs that have used loan guarantees, the ones most successful in raising local funding are the larger MFIs that use savings, certificates of deposits, and bonds for that purpose.

The Bolivian market provides an example of a microfinance industry that is mobilizing funding at a cost well under commercial bank lending rates. The two specialized microfinance banks and the nonbank Private Financial Funds have achieved robust growth, mainly through savings mobilization. In May 2006, the average cost of funding for these MFIs was about 4 percent, whereas the average cost of conventional business loans from Bolivian banks in April 2006 was about 11.5 percent. It is not surprising that these MFIs are making relatively little use of local bank loans: competitive MFIs have to replace expensive local retail borrowing with less-costly funding as they grow (Table 5).

In contrast, banks in markets like Morocco and India choose to loan to MFIs with more favorable conditions. For regulatory, political, and other reasons, banks there are willing to lend to MFIs on

| Table 5 Funding Structure of Bolivian Licensed MFIs |
|---|---|
| Deposits | 62% |
| Foreign loans | 21% |
| Loans from local 2nd tier (apex) funds | 7% |
| Loans from local banks/financial institutions | 6% |
| Other liabilities | 5% |
| Total liabilities | 100% |
wholesale terms, with interest rates of prime or less, longer terms, and recognition of the MFI’s portfolio of microloans as collateral. Few developing economies have efficient wholesale lending markets, but where they exist local bank loans are a viable funding source for MFIs that are growing to significant scale.

**The Role of Guarantees in International Lending to MFIs**

Only eight of the guarantees in the study were issued to international lenders. However, as a group, these transactions have explored the potential of guarantees in ways that most local banks deals have not.

The international lenders that have used guarantees are experienced MFI lenders. They use guarantees strategically to lower the risk in their MFI loan portfolios and in the loans they borrow to fund their lending operations. This enables specialized international lenders to access funds from commercial markets. For instance, the European Investment Fund guaranteed the top tranche of Opportunity International’s €30 million Eastern European Fund (EIF), allowing commercial investors to participate.\(^{14}\) Blue Orchard has structured a similar fund with the help of the Overseas Private Investment Corporation (OPIC). The lenders are also able to offer riskier MFI loans for larger amounts, for longer terms, and with less collateral than would be possible without guarantees. For example, the Blue Orchard fund is capable of lending to MFIs for seven-year terms.

Guarantees of international loans to MFIs are generating two important benefits in the current market. First, many of the international lenders are able to provide loans to MFIs in more favorable conditions than local banks.\(^ {15}\) Second, these international lenders are demonstrating how to use guarantees to mobilize commercial capital and fund MFIs with competitive terms, and their success may be replicated eventually by local banks in their own markets.

The first benefit can be significant. Most developing economies have inefficient banking industries, and foreign borrowing may be an attractive option despite the risks of borrowing in foreign currency. However, in a long-term view the second benefit may be more important. The growth potential of international development finance lenders and guarantors is ultimately limited by their own dependence on subsidy. And there are strong reasons for MFIs to integrate into their local funding markets, including funding stability, growth potential, and the benefits of service diversification.

**The Sustainability of Guarantee Agencies**

Guarantee agencies subsidize their guarantees. They have typically set their fees by estimating what banks and MFIs would be willing to pay, rather than by looking at the agencies’ own costs or at the true market value of the risk involved in a loan to an MFI. This practice leaves a question as to the real cost and sustainability of the guarantee programs. It also misses an opportunity to develop risk pricing information that would be useful for the industry.

Guarantor agencies generate revenue from investment income and from annual fees that may be as high as 4.5 percent of the guarantee amount.\(^ {16}\)

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\(^{14}\) For a detailed description of structured finance for MFIs at the EIF, see Jung and Eriksson (2006).

\(^{15}\) The apparent interest rate advantage of foreign loans may not always hold up when foreign exchange risks are factored in. But foreign loans often have other advantages over the conditions local banks offer MFIs, including longer loan terms and lower collateral requirements.
However, almost all of the guarantor agencies in the study receive additional financial support. In the case of the guarantee programs in public sector institutions, the operating expenses are supported by the larger agency budgets, with the exception of AFD. In the cases of the ACCION Latin American Bridge Fund, the DBMDF, and FIG, guarantee operations are supported to different degrees by staff paid by the parent organizations. FIG is the only guarantor agency that publishes its financial statements. Its financial performance is instructive: FIG’s 2005 financial and operating costs were 14 percent of an average guarantee portfolio of US$4.1 million, compared to guarantee and investment income equal to 7.4 percent, leaving a 6.6 percent net loss that had to be subsidized.

Data regarding losses resulting from loan defaults were not available for all guarantor agencies. However, IGF and ACCION have the oldest portfolios of the guarantor studies, and they report loss rates equal to 5 percent and 1 percent, respectively, of total guarantees issued. ACCION has indicated that it will double its loan loss provisions when it guarantees loans to MFIs outside of its network.

Some guarantors do adjust the price of the loan guarantee based on their assessment of the risk profile of the MFI. However, the calculations of risk price are still experimental, and guarantors generally do not make their risk price calculation explicit in the transaction. As a result, current MFI risk ratings and loan guarantee pricing benchmarks are not accessible to future commercial lenders who will need to price the risk associated with different types of MFIs.

The challenges associated with guarantor agency viability and market-based risk pricing are both related to the small size of loan guarantee transactions and the MFIs that use them. The cost of guaranteeing small bank loans to MFIs has been, and will probably continue to be, unsustainable without considerable subsidies, for three main reasons. First, the income from small transactions is insufficient to cover the costs of issuing the guarantee. These costs are roughly the same for large and small transactions, but the small guarantees generate less income. Second, the guarantor agencies incur high costs because of the inexperience of the lenders. The guarantors typically provide many services related to closing a guarantee transaction that experienced lenders commonly provide themselves or contract out to investment brokers. And finally, the guarantors also incur extraordinary costs in appraising small MFIs and assisting them with the transaction. Most small MFIs do not have reliable risk ratings that lenders can use to price risk.

The Way Forward

The loan guarantee transactions reviewed in this study represent experimentation with loans to different types of MFIs in a broad range of market conditions. The results illuminate both the benefits and limits of loan guarantees and point to what their long-term potential may be.

Many of the loan guarantees reviewed in the study represent an attempt to demonstrate the creditworthiness of nondeposit MFIs to local banks. In some cases, the loan guarantees did open the door to subsequent lending. Most loans were in local currency, and in a few cases the guarantees

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16 AFD reports: “Because guarantees don’t count as overseas development assistance, AFD receives no funds from its parent ministries to offset the cost of guarantees…. Therefore, we bill for the full cost of the guarantee: country risk, commercial risk, and AFD’s overhead costs.” The seven AFD guarantees included in this study averaged over US$4.3 million each, much larger than the average for any of the other agencies.

17 ACCION reports that the Latin American Bridge Fund has been financially self-sustaining. However, it also acknowledges that it is likely feasible only within an organization like ACCION that is able to analyze and monitor clients through parallel technical assistance or governance relationships.

18 These services include appraisal and due diligence, risk valuations, deal structuring, and final transaction closing.
overcame a regulatory obstacle to foreign financing. However, for most of the MFIs, the immediate benefits were modest. The loans were a very small percentage of the MFI’s assets, they were expensive despite large subsidies from the guarantor agencies, and banks often required other real guarantees to cover the full amount of the loan. A smaller number of MFIs in the study were able to use a loan guarantee to acquire a loan in conditions that added significant value to the MFI’s funding structure. Many of these transactions involved larger MFIs and international lenders, or they occurred in markets such as India, Benin, and Morocco where local banks are willing to offer large wholesale loans to MFIs at prime or lower interest rates, treating their portfolios of microloans as collateral.

The central observation of this Focus Note is that loan guarantees are superior to a direct loan from an international donor or funder only if the guaranteed loan helps the MFI build a competitive funding structure. For most MFIs, normal retail loans from commercial banks are simply not sustainable over the long term, especially once the MFI starts to face competition and no longer has the luxury of passing on high funding costs to its borrowers. And this is why MFIs in maturing microfinance industries use savings, certificates of deposit, bonds, and structured debt to fund their growth. The conclusion follows that guarantors will realize their greatest potential by focusing on lenders that use guarantees to structure loans to MFIs in conditions that are competitive with other funding options. In this role, guarantee facilities could become specialized, permanent, and possibly profitable components of an emerging MFI funding industry.
ANNEX

How Loan Guarantees Work

Loan guarantees involve at least three and often four parties in a loan to an MFI. The guarantor may establish the loan guarantee via any of the following mechanisms.

Stand-by letter of credit (SBLOC)

The SBLOC typically involves four institutions in the transaction. The guarantor deposits the guarantee amount in an international bank that issues an SBLOC to the local bank, which then extends the loan to the MFI. In case of default, the local bank presents evidence of default to the international bank, which releases the funds to the local bank. This is the most common guarantee instrument employed by private guarantors. The SBLOC has two main advantages. First, the guarantor’s funds are secured in an international bank and the guarantee obligation is denominated in hard currency. Second, in cases where the funding institution extends the loan to the MFI in local currency, the guarantor is not exposed to the risk of exchange rate movements.

Direct deposit in the lending institution

The guarantor may also bypass the SBLOC instrument and deposit the guarantee amount directly in the local bank. This method exposes the guarantor to the risk of local bank failure and country risk related to hard currency repatriation.

Loans to the MFI that are deposited in the lending institution

The guarantor extends a loan to the MFI, which deposits the same amount in the lending institution, which then extends the loan back to the MFI. Although the guarantor technically lends money to the MFI, the MFI uses the funds like a guarantee. This transaction typically involves a hard currency loan from the guarantor to the MFI. However, the net cost of the transaction can be lower for both parties. The guarantor typically charges a higher rate of interest on the loan than the fee for a guarantee. The MFI pays more for the loan, but is able to earn interest income by depositing the loan funds in the lending bank.

Unfunded guarantees

Some bilateral development agencies are able to pledge the commitment of their national government to honor the guarantee obligation without physically committing the guarantee funds. For example, this is the preferred contractual instrument of the USAID/DCA.

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19 Three of the guarantors have partnered with international banks to use this instrument extensively: ACCION with CITIBANK, DBMDF with Deutsche Bank, and FIG with USB.
Bibliography


