

# **Lessons learnt from Guarantee Funds: The example of the International Guarantee Fund (IGF)**

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## EXECUTIVE SUMMARY

This study has been mandated by the Swiss Agency for Development and Cooperation (SDC) as a last contribution to IGF, an initiative it supported for over 15 years.

The objective of the mandate is to review and evaluate IGF's structure, performance and target markets in the light of present development microfinance (MF) tendencies and to assess options for expansion and/or diversification with a view to achieve an economically self-sustainable operation in the short to medium run.

This report analyzes the demand for funding by IGF's target group (chapter 2) and the funding supply side, including the recent sophistication in the use of loan guarantees (LGs) (chapter 3) for both loans and investments. Chapter 4 characterizes IGF's present situation and condenses the foregoing discussion and conclusions into two scenarios for IGF's future development. The report closes with suggestions for the way forward for IGF.

First, the report analyzes the impact of IGF loan guarantees on the funding structure of their target institutions. It interprets the conditions of IGF's LG transactions and the performance of the MFIs against the results of a recent study of 100 LGs conducted by the author of this chapter for CGAP as well as several recent studies on funding trends in the MF industry, concluding that the most tangible benefit of IGF guarantees of local bank loans to MFIs has been to facilitate the MFI's first relationship with the banking sector. The loans themselves have been small and very expensive relative to the MFI's funding program; the major benefit lies in the MFI's hope that future borrowing will be on more favorable terms. However, this hope struggles against two realities in most markets: the risk profile of most small and medium MFIs is inherently difficult to measure, price and redistribute, and most local banks have little experience in measuring, pricing and redistributing risk in structured loan transactions. Even if MFIs are able to borrow subsequently without a LG, local banks typically offer "retail" loan conditions with high real collateral requirements and pricing. This has limited value to an emerging or maturing MFI that needs more structured debt as a part of their diversified funding program and greater client outreach. Where these conditions prevail, IGF's loan guarantee facility will become irrelevant to most MFIs if it focuses exclusively on local bank loans to small and medium MFIs. The emerging MFIs are likely to find better conditions from international lenders, and the maturing MFIs will need funding in conditions that local commercial banks are unable or unwilling to provide.

The following chapter characterizes MFI lifecycles and fund raising strategies as well as recent MF investment trends and products, including the increasing sophistication in risk alleviation instruments (guarantees). It presents examples of guarantees for funding and investment in MF, arriving at proposals for an alternative insertion of an IGF-type LG provider in the rapidly evolving MF-for-development industry.

The report maintains that IGF's guarantee facility could have a (more) significant impact on MFI funding, and ultimately on client impact, if it is used in the following conditions:

- The funding for the MFI must be on wholesale terms. This means that the price should be somewhere between prime retail lending rates and the bank funding rate. Loan terms should provide long term stability to the MFI's funding structure. And real collateral requirements should be minimal.

- The risk profile of the MFI must be (come) measurable, pricable and distributable. This will be the case mostly with maturing MFIs with established histories of ratings and borrowing.
- The lending institution must be committed to developing a wholesale lending business. In most markets this means developing capacity to syndicate loans in tranches with different risk profiles for different lenders. Some banks may prefer to do this through issues of commercial paper or bonds.

IGF faces a strategic decision about how it will create value for the microfinance market. The analysis of IGF's situation shows a dedicated and efficient administration of its programme in the past years, but also the limited impact and a high dependency from substantial new donations to continue its operation in its present form. Scenario 1 refers to a continuation of the present mode of operation of IGF with minimal changes (e.g. an operational and institutional separation between the guarantee management part and the field work on which it is based). Scenario 2 proposes a repositioning of IGF in the present MF trends and market environment; the essential component of this reorientation is a shift in IGF's clientele, from the current focus on MFIs as the client to a focus on the agents who are structuring and funding wholesale lending transactions.

The report concludes by outlining the steps that IGF can take to formulate and implement its future course of action.

## 1. Introduction

The International Guarantee Fund (IGF) provides loan guarantees (LGs) to smaller credit-providing non-governmental organizations (NGOs) including agricultural producer cooperatives in countries of Latin America and Africa. The Swiss NGO RAFAD started this program around 1990; towards the end of the decade, it turned its guarantee portfolio over to the IGF, a cooperative governed by Swiss law which it established in 1996.

The Swiss Agency for Development and Cooperation (SDC) has supported the development of RAFAD and, subsequently, of IGF since its inception with both a counter guarantee facility conceded to UBS, IGF's guarantee emission bank, and with a yearly subsidy to cover part of the administrative cost, up to the end of 2005.

As a last contribution, SDC finances, at the request of IGF, the present study of scenarios for IGF's future development, including a workshop on LGs as risk reduction instruments at the end of the assignment. SDC mandated TULUM to put together a team to comply with this task. TULUM subcontracted

- Mark Flaming (Portland, Oregon), a microfinance (MF) specialist, and
- Symbiotics (Roland Dominicé) in Geneva, a service provider for MF investors and fund managers.

The *objective* of this mandate is to review and evaluate IGF's structure, performance and target markets in the light of present development microfinance tendencies and to assess options for expansion and/or diversification with a view to achieve an economically self-sustainable operation in the short to medium run.

The consultancy approached the tasks at hand in the following way, as reflected in this report:

- a) a prospective evaluation of IGF's instruments and performance looking at the usefulness of IGF-type instruments (LGs) within present MF trends and funding possibilities,
- b) discerning options for the provision of risk alleviation instruments which help structure microfinance investment vehicles with a view to comply with IGF's mission, and
- c) suggesting decisions to be taken by IGF to comply with its mission in response to MF market trends, including terms of reference for a consultancy to define a viable future structure for IGF based on decisions taken by the IGF.

So far, LGs have been provided by a large number of agents – local, regional, national, and international – in a large number of countries and for a variety of purposes. Usually, the justification for such LG provision has been an assumed “market failure”: that specific target groups failed to get access to credit for reasons linked to “the market” (i.e. credit suppliers). With the improvement of financial enabling environments since the 1990s and, as a consequence, the growth of microfinance, this discussion has become more empirical: it is possible today to discern evolutionary patterns of microfinance and analyze instruments like LGs in this context. This is what this mandate purports to do for the case of the IGF. It will not present an evaluation of IGF as such, but show how it is embedded in the upcoming microfinance trends and where chances to promote MF in favour or poor target groups arise.

The mandate has been carried out between January and June 2006 and included visits to, and contacts at distance with, IGF clients in Latin America (Peru and Nicaragua) and Africa (Togo and Bénin), next to its headquarter in Geneva.

## **2. Microfinance development trends and the impact of IGF loan guarantees on the funding structure of MFIs** (Mark Flaming)

### *2.1 Approach to evaluate the effectiveness of LGs and its impact on MFIs*

IGF LG operations are guided by three explicit assumptions:

- small and medium size MFIs play a unique role in delivering financial services to poor microentrepreneurs;
- these MFIs face a funding gap caused by concentration of development finance in more established MFIs; and,
- local borrowing is a preferred funding source for small and medium size MFIs.

Consequently, IGF targets what it considers to be emerging MFIs with limited funding options, employing the guarantee facility to provide additional collateral for loans, preferably from local lenders.

This chapter compares these assumptions to broader microfinance industry trends and assesses the impact of the guaranteed loans on the MFIs. It interprets the conditions of IGF's LG transactions and the performance of the MFIs against the results of a recent study of 100 LGs conducted by the author for CGAP as well as several recent studies on funding trends in the microfinance industry. IGF provided transaction information, and financial data was collected either from public sources or directly from IGF's client MFIs; a sample of MFI managers were interviewed by telephone.

The overview of industry trends in section 2.2 provides a framework to revisit the assumption that smaller MFIs are worthy of exclusive support in all markets. The overview also demonstrates that MFIs face funding challenges at all stages of their development and that borrowing is only an attractive funding option under specific circumstances. Section 2.3 tests these observations by examining the impact of IGF LGs in the context of two specific markets: Nicaragua and Benin. Section 2.4 looks more broadly at IGF transactions with specific measures of cost, leverage, contribution to asset growth and funding diversification, and section 2.5 reviews the scope of IGF experience with its guarantee facility. Section 2.6 presents conclusions of this assessment of the impact of IGF loan guarantees (LGs) on the microfinance institutions (MFIs), focusing on the question of how much the LGs accomplish the IGF objective of supporting MFIs that provide financial services to the poor.

IGF's future course of action will depend on whether IGF's stakeholders believe that

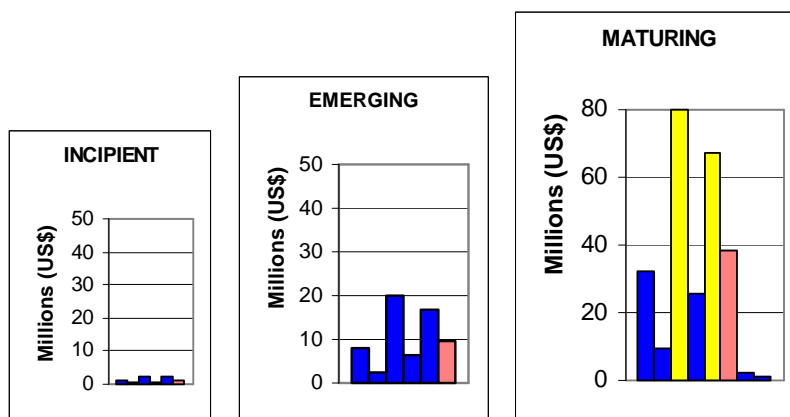
- a) the benefits of the current modus operandi are worthy of future subsidies, or that
- b) modifications to the facility could improve both IGF's financial position and the impact of the guarantee facility. This chapter focuses primarily on the effectiveness of the LG instrument and its impact on MFIs.

### *2.2 How do MFI funding opportunities and client impact evolve with the development of a local microfinance industry?*

In most markets, microfinance begins with the launch of incipient MFIs and develops into an entire financial industry complete with regulation, funding markets, and support service providers. In this process, three trends shape MFI funding gaps and the impact of services on

clients: the evolution of the institutional structure of the retail market (the MFIs), the evolution of financial services, and the evolution of prices.

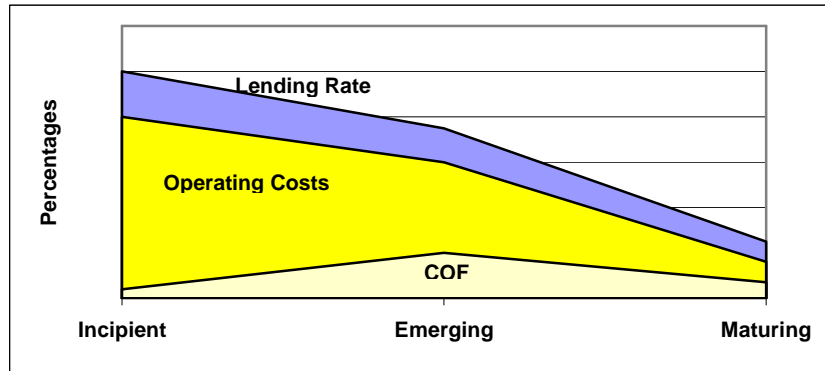
The following graphs depict the evolution of institutional structure (different MFIs) over three phases of market development.



In the incipient phase, non-profit organizations launch credit operations by importing international best practice. Their closest cousins are existing mutual credit and savings institutions (mutual societies). The mutual societies are often fragmented, weak and poorly regulated, but not always; in some markets they are well established with significant membership. The market emerges as more MFIs and some mutual societies establish themselves and are able to sustain growth. At some point, the leading MFIs make the necessary institutional changes to capture savings or access funding markets to achieve substantial scale. By this time, the largest MFIs and mutual societies account for the majority of market share.

This evolutionary cycle produces two important benefits for clients. First, maturing markets offer clients a broader range of financial services. MFIs in incipient and emerging markets tend to focus primarily on extending credit, and savings services are limited by the capacity of the mutual societies. Only in maturing markets do MFIs have the scale and institutional capacity to develop savings, money transfer and payment services, and other value adding financial products.

Secondly, maturing markets are characterized by conditions that reduce the cost of services to the clients. Competition and economies of scale reduce lending rates and MFI operating costs, and MFIs begin the shift towards less costly forms of funding. The graph below depicts this development.



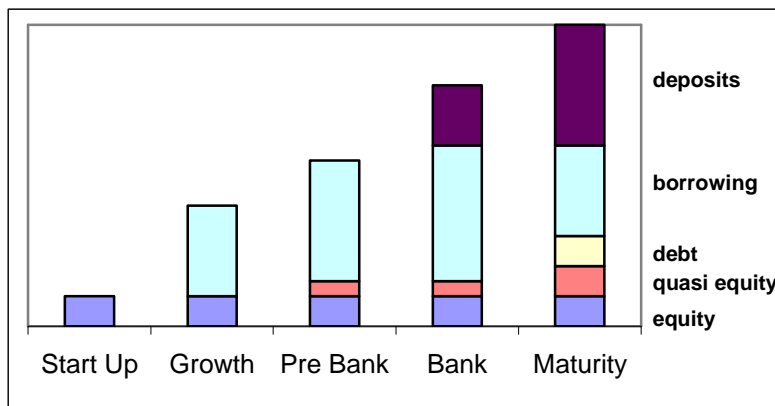
In summary, incipient markets provide clients with their first access to credit services at high prices. Emerging markets expand that access to expensive credit. Maturing markets provide an array of financial services at increasingly lower prices.

The value added of any particular MFI is relative to its position in the market. In the incipient phase, small MFIs essentially launch the industry. In the emerging phase, the largest MFIs make the most significant contribution to the development of the industry by expanding services, establishing the credibility of microfinance and demanding a more robust funding market. In this phase, new market entrants may play a positive role by product or institutional innovation. However, less visionary MFIs may also contribute to a proliferation of donor-dependent institutions that have a negative effect on client discipline and even on client welfare.<sup>1</sup> The MFIs that transform into regulated deposit-taking institutions generate the significant benefits of the maturing markets. They are typically the institutions that expand services and lead the reduction of prices.

This simplified scenario of market development does not imply that small and medium size MFIs cease to be important to an emerging microfinance industry. It merely illustrates two points: client impact improves with *market development*, and, the leading MFIs play a relatively more important role in developing the industry and providing new benefits to clients as the market develops. IGF's assumptions about the unique contribution of small and medium MFIs may well be valid in most incipient markets, but they do not appear to account for the realities of emerging and maturing industries.

Likewise, the assumption about the significance of borrowing to an MFI's funding program needs to account for how the importance of borrowing changes as an MFI develops. The following table illustrates this evolution.

<sup>1</sup> This effect is discussed later in the document with reference to a study conducted in Nicaragua.



MFIs are typically launched with grant equity and resort to borrowing to fund initial growth. Successful MFIs quickly exhaust their sources of subsidized loans and turn to funders that charge commercial prices. In most emerging markets, MFIs can still charge high enough lending rates to cover the high cost of commercial “retail” borrowing. However, markets mature and MFIs develop capacity to fund sustained growth at lower rates. MFIs turn to deposit mobilization, bonds, and commercial paper for this purpose. Borrowing still plays a critical role in this process because it is typically the most agile form of funding. However, it becomes increasingly important to structure loans to achieve lower costs, longer term, and larger amounts. In most markets, retail borrowing from commercial lenders becomes too expensive and limited as an MFI and the market mature.

It is important to point out that MFIs face funding challenges at all stages of development. IGF’s assertion that a small number of MFIs absorb a large share of development funding is well documented in recent studies.<sup>2</sup> However, development funding is not only concentrated in a small number of MFIs, it is also delivered primarily in the form of grants and small loans.<sup>3</sup> MFIs seeking subordinated debt, syndicated/structured loans, or attempting to issue debt securities find fewer options.

This broader view of MFI and market development helps to explain why the highest demand from LGs comes from small and medium MFIs in emerging markets.<sup>4</sup> Such MFIs have to borrow from all available sources to fund the rapid growth of credit operations, and their markets still allow lending rates high enough to cover the funding costs. From this perspective, LGs do not add significantly more value than any other form of development lending, unless the LG can facilitate higher loan amounts, lower pricing, or longer term. Clearly, a facility that limits operations to guaranteeing local retail loans to MFIs forgoes the opportunity to support an MFI that is seeking more sophisticated forms of funding.

<sup>2</sup> Julie Abrams and Gautam Ivatury, *The Market for Foreign Investment in Microfinance*, CGAP Focus Note No. 30, August 2005.

<sup>3</sup> Marc de Sousa-Shields and Cheryl Frankiewicz, *Financing Microfinance: The Context for Transitions to Private Capital*. USAID MicroReport #8, December 2004.

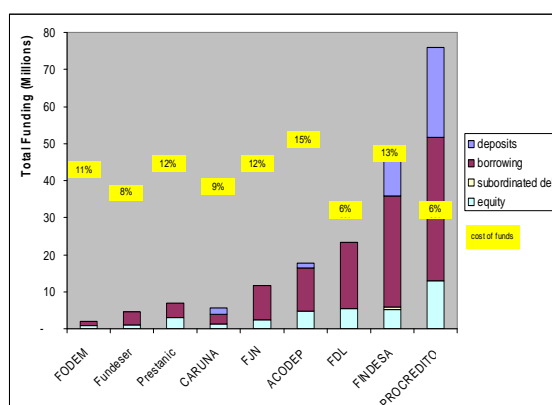
<sup>4</sup> Mark Flaming, *Guaranteed Loans To Microfinance Institutions: How Much Do They Help Access Local Funding Markets?* CGAP Focus Note pending publication.

## 2.3 Analysis of countries with strong IGF engagement

### 2.3.1 Test Market 1: Nicaragua

Nicaragua has an emerging microfinance industry led by two maturing MFIs. The supply of microcredit has increased an average of 26% a year since 1999 with impressive geographical and sector distribution. The retail industry has followed a steady course of consolidation as the largest MFIs have sustained robust growth and captured the bulk of the credit market. Six of the largest MFIs have accounted for 63% of the growth of credit clients since 1999. At the same time, donors have funded a proliferation of smaller MFIs, resulting in a non-optimal fragmentation of the supply side of the market. ASOMIF, the association of MFIs, has 21 members that are generally established and performing MFIs. However, a 2005 study estimated an additional 200 very small and generally weak credit programs. Effective interest rates have not declined significantly since 1999, producing portfolio yields of around 37%.

The best of the emerging MFIs have led the expansion of the credit market. However, effective interest rates have not declined significantly. Only the two regulated MFIs, PROCREDITO and FINDESA, have recently initiated non-credit services, specifically savings and money transfers. The credit union sector is weak. A 2002 World Bank study of the impact of credit in Nicaragua demonstrated the ill-effects of the fragmented credit market. The study determined that at least the poorest 50% of the population suffered a net loss in household income from borrowing. And the primary cause of this was weak MFIs that targeted the poorest population with credit.<sup>5</sup> The next significant advance in client impact in the Nicaraguan market will come from MFIs capable of offering a broad range of credit and savings services and of reducing lending rates by more efficient economies of scale and lower funding costs. PROCREDIT in particular has demonstrated this trend and set new benchmarks for service delivery and funding strategies. The other MFI managers interviewed in the study all acknowledged that savings mobilization will play a prominent role in their long term funding programs; most reported that their respective board of directors were preparing for eventual transformation into a regulated financial institution.



Nicaraguan MFIs exploit a rich but very fragmented funding market. The 2005 CGAP CLEAR report identified over 60 sources of funding for MFIs with \$135 million in loans outstanding in over 200 institutions, and an additional \$110 million programmed for 2005. Add to this the international sources of funding. For the largest growth oriented MFIs, the challenge is finding funding in terms that facilitate their long term objective of transformation, sustained growth and reducing funding costs. Local commercial banks are charging around 12% for MFI loans, and this is expensive compared to other sources. Forward looking MFIs are eager to consolidate their current retail borrowing into more long term and less expensive debt. International sources such as the Central American Bank for Economic Integration (CABEI), or even more commercial sources such as Blue Orchard or

<sup>5</sup> Arianna Legovini, *The Distributional Impact of Loans in Nicaragua: Are the Poor Worse Off?* World Bank 2002.

ETIMOS, are offering conditions closer to what MFIs will need to gradually reduce their dependence on expensive retail loans.

This overview of the Nicaraguan industry provides a context for assessing the precision of IGF's strategic assumptions and the impact of its LGs.

➤ *Identifying the MFIs that are creating value for clients*

In an emerging market like Nicaragua's, IGF's stated preference for small and medium MFIs does not, by itself, account for which MFIs are generating value for the market. Generally, it will be the MFIs that move quickly towards transformation and deposit taking that will achieve that greatest scale, scope of service and efficiency and therefore value for the poor. Some of the MFIs that have benefited from IGF guarantees – FJN and ACODEP – are likely to follow this path soon. MFIs that continue to operate as non-profit credit facilities will be limited in scale and in their ability to bring lending rates down. Persistent fragmentation of the market into small MFIs will create unhealthy stress for strong MFIs, hinder cost reduction, and generate a net cost for the poorest borrowers. IGF's client MFIs have played important roles in the incipient and emerging phases of the Nicaraguan microfinance industry. Their contribution will increase, or decline, largely as a function of their funding diversification, scale and service expansion.

➤ *The funding gaps*

The funding that the maturing MFIs will need is not readily available in the Nicaraguan market, despite the large number of lenders. The emerging MFIs are currently juggling the multiple reporting requirements and lending directives of many small lenders. Equity and subordinated debt will be important to the next MFIs that transform into limited liability companies and apply for a banking license. Structured debt, and eventually bond issues, are the most likely sources of debt that will add value to their funding structure.

➤ *The relative benefits of local borrowing*

Local commercial lenders offer limited benefits for maturing MFIs. Local currency loans are indexed to the dollar and offer no currency risk advantage. Local commercial banks treat MFIs as retail customers, and their loans are expensive and limited in scale. There is little evidence to suggest that this will change in the foreseeable future. As the table above indicates, most of the non-deposit MFIs have a COF of around 12-15%.<sup>6</sup> They will need to reduce this drastically to keep pace with trend of 6% set by PROCREDIT. This is unlikely to happen through retail borrowing from commercial banks. The cost of IGF *guaranteed local loans* was around 15% for most MFIs. Local banks are demanding around 12% with conservative real collateral requirements, a rate that is unsustainable in the long run. In the short term, the willingness of the international development finance facilities to accept MFI portfolio as collateral is a significant advantage over the conservative collateral demands of local banks. In the long run, these same lenders are also more likely to structure better debt packages.

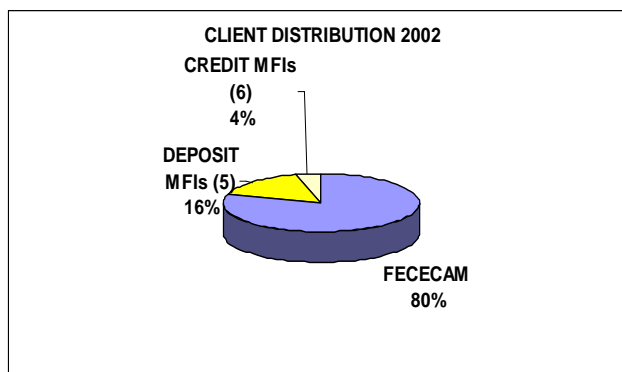
For maturing MFIs, the structure and price of their future debt will be more important than its origin. The market is ripe for the leading MFIs to follow PROCREDITO's lead and transform into energetic financial intermediaries. For these MFIs, it is easier to imagine the benefits of a large, syndicated loan with a partial guarantee; the value of a commercial retail loan is less evident.

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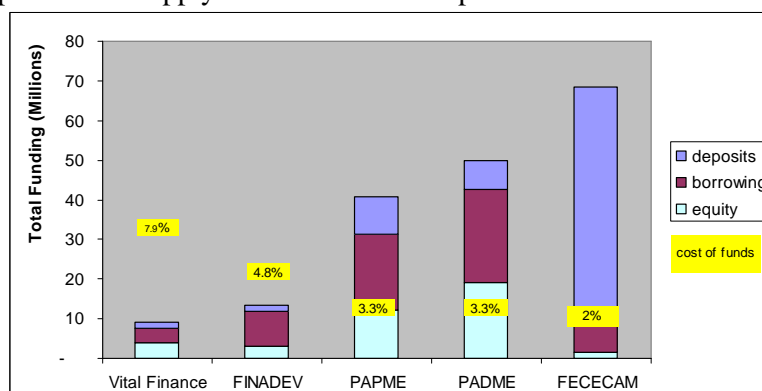
<sup>6</sup> FDL is an exception at 6%, but this is due to the effect of subsidized loans inherited through Nitlapan.

### 2.3.2 Test Market 2: Benin

In comparison to Nicaragua, the Benin microfinance industry is more deeply rooted in the country's long savings tradition. The non-bank sector (*système décentralisé*) is dominated by the mutual societies. FECECAM had 80% of market clients in 2002. The 5 leading, deposit MFIs accounted for 16% of clients, and the other six credit MFIs only 4%. In general, the mutual societies have developed the savings market and the MFIs have expanded the supply of microcredit best practice.



The deposit MFIs have grown to significant scale. Early savings services have been tied to their credit programs, but from a funding perspective deposits have played an important role in any of the MFIs that have achieved scale.



The significance of savings for the cost of funding (COF) is also evident in the graph. Domestic bank and donor financing is available in Benin, and the former is even six times higher than the latter. Nevertheless, domestic retail borrowing is expensive. At around 7.5% (without a guarantee), the cost of commercial borrowing is uncompetitive with the trend towards lower COF of around 3% in the deposit institutions.

All of these factors favor an institutional and funding structure with robust savings mobilization capacity. This trend will likely permit MFIs to achieve significant economies of scale, provide a range of financial services and maintain low funding costs. All of this promises benefits to the clients, and reduces the risk of the perverse effect of high cost credit to the poorer segments of the population.

#### ➤ *Identifying the MFIs that are creating value for clients*

There may be opportunities to create additional value with new MFIs that introduce innovative financial service or reach new market niches. Undoubtedly, the larger deposit MFIs will create value as they expand services and reduce costs. Both initiatives will contribute to industry development.

#### ➤ *The funding gaps*

As deposits provide an increasing percentage of the MFI's funding, the MFIs will want to use other forms of debt financing to *complement* their funding structure with longer term and larger deals.

➤ *The relative benefits of local borrowing*

Local borrowing will have to offer robust volume and loan term well under the retail lending rate for it to add significant value in the Benin market.

#### 2.4 *The impact of IGF loan guarantees*

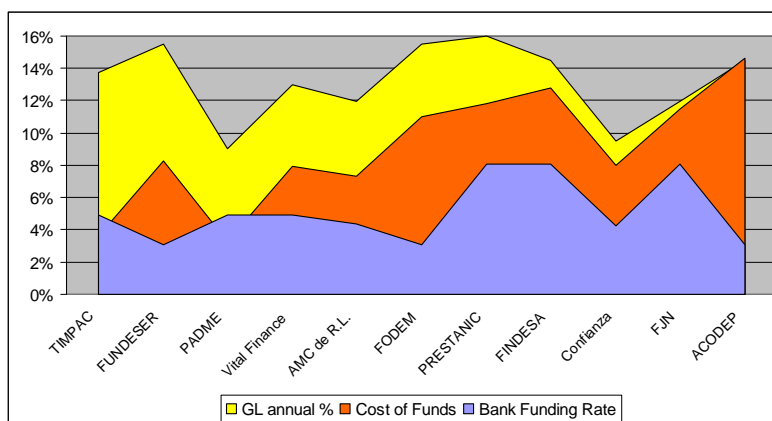
The following section measures impact indicators for a sample set of 21 IGF transactions. It is important to stress that the impact of any single transaction is specific to its market, and should be measured in the context of a market review similar to the ones presented for Nicaragua and Benin. Nevertheless, the following indicators support some general observations about IGF transactions that will be useful in future policy discussions.

##### 2.4.1 Access to lenders

The most obvious benefit of IGF LGs is that they facilitate a loan from a lender who is otherwise unwilling to lend to the MFI. It is important to recognize that at the time of the transaction, the MFIs place significant value on being able to initiate a borrowing relationship with the lenders. Most of the MFIs are growing rapidly and exploring all available sources of borrowing. And the MFIs are especially eager to test the potential of local banks as a long term funding source. The LGs open these doors for the MFIs. The following sections attempt to measure the immediate impact of the guaranteed loans. Whether local lenders eventually become worthwhile funding sources for MFIs will depend upon how the market develops.

##### 2.4.2 The cost of guaranteed loans

Guaranteed loans are generally very expensive for MFIs. In general, the guaranteed loans have been the most expensive source of funding for MFIs whose cost of funds is already well above the local bank funding rate (see chart).

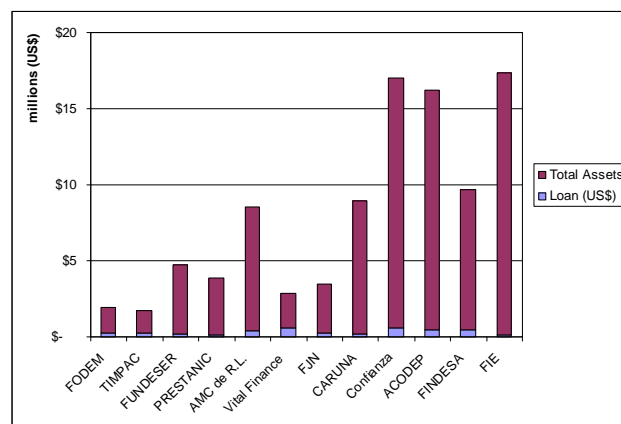


MFIs are clearly paying a premium for guaranteed loans. The transaction may be providing another benefit that is important to the MFI (access to domestic commercial funding), but the price of the funding demonstrates that the loan itself is probably too costly to be a significant source of expansion funding. Most importantly, the pricing trend indicates that most lenders

are still treating the MFIs as risky retail clients, even with the LG. Most MFIs conduct the transaction with the expectation that subsequent loans with the local lender will be in conditions favorable to the MFIs long term funding program. This outcome will depend on evolving market conditions.

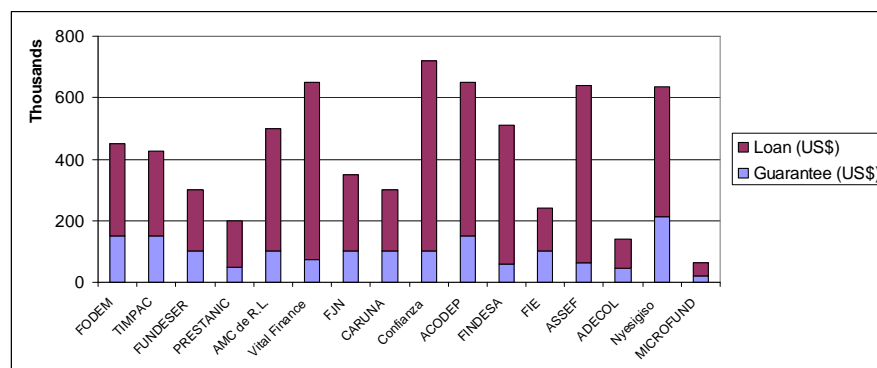
### 2.4.3 Loan:Asset ratio

As the table illustrates, the guaranteed loans made a relatively modest contribution to the MFIs' assets in the year of the transaction. This helps explain why the MFIs are able to pay a price for the loan that is well above their average cost of funds: the loan is only a small portion of their funding. The small loan:asset ratio also suggests that the MFIs did the transaction primarily to build a future relationship with the lender. Nevertheless, the table also demonstrates that the lenders would have to increase subsequent lending by substantial amounts to make a significant contribution to MFI funding. As noted earlier, the price would also have to decline substantially.



### 2.4.4 Leverage Redefined

IGF, like most guarantors, compares the amount of the loan to the guarantee amount as a measure of “leverage.” By this measure, IGF transactions have a very high loan:guarantee ratio, about 3 on average (see chart below).



However, the more meaningful measure of “leverage” would compare the loan guarantee to the amount of the loan that is unsecured. In most cases, banks do lend more money to the MFIs with an IGF guarantee, but they still require the MFI to provide “real” (cash, securities

or land) collateral for the full amount of the loan. In such cases, the LG provides no leverage at all. The LG merely “rents” additional real collateral to the MFI.

The ultimate goal for the MFI is to be able to secure loans by using the portfolio as collateral. This allows the MFI to employ all of its funding in the portfolio. For example, a fully leveraged US\$1 million loan would require a \$300,000 loan guarantee and \$700,000 of portfolio as collateral. This data from IGF transactions was not available during the study. However, MFI managers in Latin American countries indicated that banks continue to be very conservative about “real” guarantees, and that this is a considerable barrier to using bank loans of significant size.

This definition of leverage reflects the most fundamental benefit of using loan guarantees. Loan guarantees add value to a transaction if they price and redistribute risk in a way to create loan conditions that are favorable to the lender and borrower. In practice, the risk of the MFI is not explicitly priced in IGF transactions. Many lenders are simply charging their normal corporate rate and requiring real collateral for most if not all of the loan amount. In these cases, the guarantee is simply giving extra comfort for the bank, and the MFI is paying the risk premium twice. This may be acceptable to the MFI for the first transaction. But for emerging MFIs local borrowing will cease to become attractive unless local lenders are able to structure loans to MFIs at something closer to interbank rates using portfolio as collateral.

## *2.5 The scope of IGF experience*

IGF’s experience with LGs has been, in practice, more wide-ranging than the current strategy indicates. A broader look at the history of IGF’s transactions help illustrate that the current lending guidelines (see assumptions indicated at the start of this chapter) do not apply convincingly to a number of some of IGF’s most effective MFIs.

Some of the MFIs that used IGF guarantees in their emerging phase have gone on to become maturing MFIs that are leading their markets. FIE in Bolivia and FINDESA in Nicaragua are two examples. Banco Solidario (Ecuador) and PADME (Benin) were large institutions at the time of the transaction. These institutions are not “second and third level” MFIs, yet they are leading their respective markets in client impact.

Many of IGF transactions have been conducted with the very MFIs where donors have concentrated their support. For example, of the 10 MFIs in Abrams and Ivatury’s list of MFIs with the heaviest concentration of donor/foreign investors, 6 have used IGF guarantees.

At least in the past, IGF LGs supported loans from foreign lenders. In the case of Nicaragua, these foreign lenders provided more attractive terms than the more recent loans with local banks. The recent portfolio guarantees with PADME and Banco Solidario also demonstrate demand for IGF’s proposed addition of portfolio and “prudential” guarantees to the facility.

The fact that IGF practice is broader than its current guidelines suggest does not reflect negatively on past IGF transactions. Rather, some of these experiences demonstrate the potential for broadening the scope of the guarantee facility.

## 2.6 Conclusion

This chapter concludes that the most tangible benefit of IGF guarantees of local bank loans to MFIs has been to facilitate the MFI's first relationship with the banking sector. The loans themselves have been small and very expensive relative to the MFI's funding program; the major benefit lies in the MFI's hope that future borrowing will be on more favorable terms.

This hope struggles against two realities in most markets. The risk profile of most small and medium MFIs is inherently difficult to measure, price and redistribute. And most local banks have little experience in measuring, pricing and redistributing risk in structured loan transactions. Even if MFIs are able to borrow subsequently without a LG, local banks typically offer "retail" loan conditions with high real collateral requirements and pricing. This has limited value to an emerging or maturing MFI that needs more structured debt as a part of their diversified funding program and greater client outreach.

Where these conditions prevail, IGF's loan guarantee facility will become irrelevant to most MFIs if it focuses exclusively on local bank loans to small and medium MFIs. The emerging MFIs are likely to find better conditions from international lenders, and the maturing MFIs will need funding in conditions that local commercial banks are unable or unwilling to provide.

At the same time, IGF's guarantee facility could have a significant impact on MFI funding, and ultimately on client impact, if it is used in the following conditions:

- The funding for the MFI must be on wholesale terms. This means that the price should be somewhere between prime retail lending rates and the bank funding rate. Loan terms should provide long term stability to the MFI's funding structure. And real collateral requirements should be minimal.
- The risk profile of the MFI must be (come) measurable, pricable and distributable. This will be the case mostly with maturing MFIs with established histories of ratings and borrowing.
- The lending institution must be committed to developing a wholesale lending business. In most markets this means developing capacity to syndicate loans in tranches with different risk profiles for different lenders. Some banks may prefer to do this through issues of commercial paper or bonds.

## 3. Evolving MFI investment/funding trends and products (Symbiotics)

After the analysis of the demand for funding by MFIs, we now look at how the microfinance funding side evolves.

### 3.1 MFI Lifecycles and Fund Raising Strategies

#### 3.1.1 Lifecycle concepts and data

In its 2004 study "Financing Microfinance Institutions: The Context for Transitions to Private Capital"<sup>7</sup>, USAID uses as a starting point the business lifecycle through which

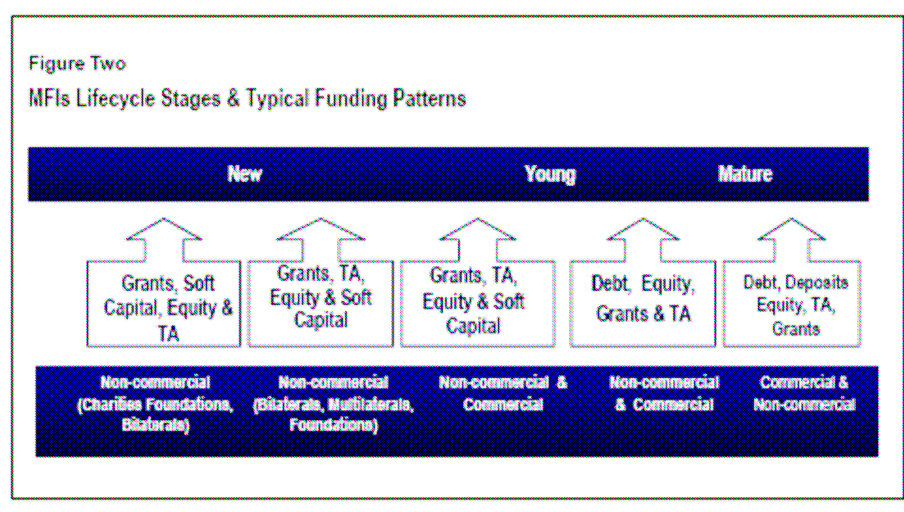
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<sup>7</sup> de Sousa-Shields, Marc & Cheryl Frankiewicz, 2004; Financing Microfinance Institutions: The Context for Transitions to Private Capital; United States Agency for International Development (USAID).

microfinance institutions evolve, from new, young and eventually mature MFIs. As indicated in the previous chapter, to such lifecycle path corresponds a funding pattern, from non commercial funding to commercial funding, or as many funding structures and strategies as there are stages in this process. The study conceptualizes five phases, evolving from grants and technical assistance, into equity, soft loans, commercial debt and eventually deposits.

**Figure 1: USAID Funding Lifecycle:**

Grants & TA >> Equity >> Soft loans >> Commercial Debt >> Deposits



According to such study, new MFIs have 31% of commercial funding while mature MFIs have 79% of commercial funding. Among the latter group, the more profitable ones disclose over 90% of commercial funding.

In a more recent case study, the Microfinance Centre<sup>8</sup> mentions that new microfinance institutions in Eastern Europe and Central Asia (below four years of age) have only 4% on average of commercial funding liabilities and 0.3 debt to equity ratio. Young microfinance institutions in the same region (five to eight years of age) access 15% of commercial funding and leverage their equity 0.6 times. Finally mature institutions (above eight years of age) leverage 1.5 times their equity and access 31% of commercial funding. The same study offers an identical analysis of such indicators over the portfolio growth over time, confirming similar trend.

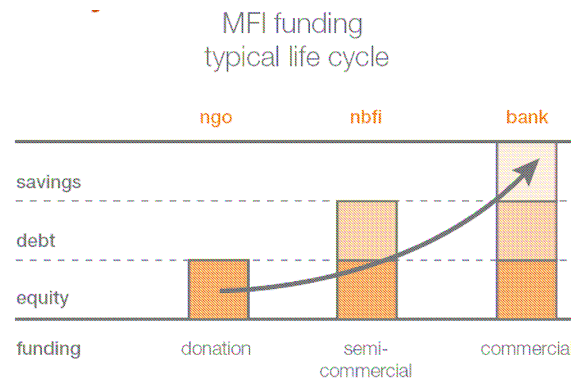
Symbiotics conceptualizes such life cycle by proposing three stages (NGO, NBF and Bank) corresponding to three liability structures (equity, equity-debt, equity-debt-savings) corresponding to three liability strategies (donation, semi-commercial, commercial).

<sup>8</sup> Pytkowska, Justina; 2006; Funding structure of non-governmental and non-bank financial institutions in Eastern Europe and Central Asia (ECA); MFC Newsletter Issue No. 1/2006.

Using another sample of MFIs, Symbiotics benchmarks a 3.8 leverage (debt to equity ratio) among 48 microfinance institutions reporting on its database as of December 2005; 3.16 for NGOs; 3.85 for NBFIs and 4.39 for Banks.

Similarly, the savings ratio over the same sample of MFIs concludes to an average of 24.2%; the savings ratio for NGOs only is at 1.9%; 23.4% for NBFIs and 42.7% for Banks.

**Figure 2: Three stage life cycle**



### 3.1.2 Implications for the use of guarantees and guarantee funds

Different studies, using different samples of data, will propose different figures but all point to the same lifecycle trend of start-up MFIs bent towards small debt leverage and larger donation dependency that are evolving over time towards more leveraged and commercial institutions.

From the point of view of a commercial provision of LGs, the first conclusion is that the early stage microfinance institutions receive grants and technical assistance and more than anything else need seed equity. They are not a natural market for guarantee providers as neither their liability structure nor their funding strategy pushes them towards a risk alleviation facility providing collateral to raise debt. Guarantee providers following the microfinance funding demand will thus naturally target MFIs into a second stage of development, in their growth phase, when they are looking to leverage their equity.

The second conclusion of this evidence on MFI lifecycle and funding patterns is that guarantees are per se not a funding product and as such do not appear as part of a funding structure or strategy. Guarantees are a means and not an end to specific funding strategies. For growth MFIs leveraging their equity, guarantees provide collateral (in the form of letters of credit) to lenders not fully at ease with providing unsecured funding. The client of the guarantee in this case is the lender rather than the MFI. For large mature MFIs, having achieved a significant amount of leverage, portfolio guarantees can be a tool for restructuring their capital base, generating capital relief effects or still alleviating the risk of selected portions of their assets. The clients of the guarantee in this case are large mature borrowers.

### 3.2 *Microfinance Investment Trends and Products*

#### 3.2.1 Market Size

Microfinance, or in its widest sense financial services for the poor, in 2000 was commonly believed to concern five hundred million micro-entrepreneurs worldwide, each potentially requiring on average five hundred dollars per annum to sustain their family and activities. Such hypothesis advanced among others by the United Nations assumes a target market of 250 billion dollars. Similarly, it was commonly believed that such market was satisfied up to 10 to 15% percent of such demand by a few thousand MFIs, of which a few hundreds were regulated and sustainable and a few dozen had banking licenses and profitable returns. The target market was assumed at about three billion dollars, with very large unfulfilled demand and growing rapidly.

The 2005 Micro-Credit Survey<sup>9</sup> acknowledges over 3164 microfinance institutions reporting over 92 million micro-enterprise clients worldwide, of which over 70% are among the poorest. Its 2000 survey reported market data at one third of its current size. Although the Micro-Credit Survey doesn't exhaustively survey all of the financial services for the poor worldwide, it is the closest study to such effort. If we assume an average loan of five hundred to a thousand dollars, the market size using such data is assumed at 50 to 100 billion dollars. Such assumption would conclude that 20 to 40% of the market assumed by the United Nations is today covered. It also projects a 40% annual growth of the industry in the past five years, with a market at 15 to 30 billion dollars in 2000.

The World Bank, in a study on "foreign direct investments in microfinance"<sup>10</sup>, concluded that foreign funders had invested US\$ 1 billion in microfinance worldwide and that 90% of such funding came directly or indirectly from the public sector. The study estimated the total microfinance market at US\$ 15 billion, implying that foreign investors contributed only up to 7% of the capital currently invested in microfinance, and the foreign private sector less than 1% of such market.

Market size is still not firmly established but all surveys and studies point to a multi-billion investment market growing annually by double digit numbers and still rather far from having attained its full capacity. Also, foreign private investors are rather new to this market and until recently insignificant.

#### 3.2.2 Investment vehicles and fund managers

Indeed, a few years ago, foreign investment vehicles were limited to a few dozen initiatives often of only a few million dollars very seldom using non subsidized funding. In 2003, the ADA "International Investment Funds"<sup>11</sup> census counted 58 microfinance foreign investment funds, of which the large majority received and provided blended social capital. Only three funds were reported as having private commercial investors and investment focus.

<sup>9</sup> Daley-Harris, Sam; 2005; State of the Microcredit Summit Campaign Report 2005; Microcredit Summit Campaign.

<sup>10</sup> Foreign Investment in Microfinance: Debt and Equity from Quasi-Commercial Investors; 2004; FocusNote No. 25; Consultative Group to Assist the Poorest (CGAP).

<sup>11</sup> Goodman, Patrick; 2005; Microfinance Investment Funds: Key Features, Appui au Développement Autonome (ADA).

Today the number of microfinance investment vehicles is believed to have doubled, and the portion of commercial and semi-commercial money is believed to have grown significantly within such foreign investments. The Symbiotics directory counts today 62 microfinance ‘investment vehicles’, 138 ‘donation and grant making’ institutions and over two hundred institutions investing and managing funds invested in microfinance. The 2005 update of the ADA study, points to 38 specialized key microfinance investment funds that total US\$ 869 million. Announced funding facilities for 2006/2007 promise additional capital beyond that amount.

The foreign investment fund market remains a very atomized market, fairly opaque and hybrid, but the growth in number and volume of funds is patent. Off-shore microfinance investment vehicles seem also to have evolved in a lifecycle specialization and sophistication, witnessing the birth of many new funding facilities, which we could conceptualize into a investment vehicle lifecycle (see figure 3).

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### Figure 3: Microfinance Investment Fund Lifecycle

Donor agencies >> network equity funds >> pioneer debt funds >> balanced mutual funds

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Up to the end of the 1990s, foreign investment in microfinance were largely driven by donors, international financial institutions and government agencies, providing seed money and technical assistance to assist local micro-credit programs or build new ones.

The end of the 1990s saw the emergence of a few microfinance network equity funds, transforming such public sector seed money into equity and bundling it up into capital investment vehicles for foreign based microfinance network, such as the Accion “ProFund”, the IPC “IMI fund” or the Opportunity International “OTI fund”.

The end of the 1990s also saw the emergence of a few pioneer debt funds lending to such foreign controlled microfinance programs, using the public sector capital as a risk alleviator to leverage the portfolios of such institutions. The target borrowers of such funds, largely referred to as the ‘usual suspects’ or top of the pyramid of a fast growing sector, oligopolized the large majority of foreign investments in microfinance. This phenomenon was coined by the 2002 CGAP debate “Water, water everywhere, but not a drop to drink”<sup>12</sup>.

The pioneer microfinance networks and their dedicated donors have achieved an outstanding and decisive contribution for the microfinance industry, imposing by proof of result and success microfinance on the global development agenda, even promoting it as a key to reaching the millennium development goals of the United Nations.

The flipside of this stage of development of the industry nevertheless locked somewhat microfinance investments into a small club of practitioners in American and European financial centers, channelling capital into a very small portion of the market, whereas the bigger industry remained this multi-billion arena with thousands of actors financing dozens of

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<sup>12</sup> *Water, water everywhere, but not a drop to drink*; 2002; Donor Brief No. 3, Consultative Group to Assist the Poorest (CGAP).

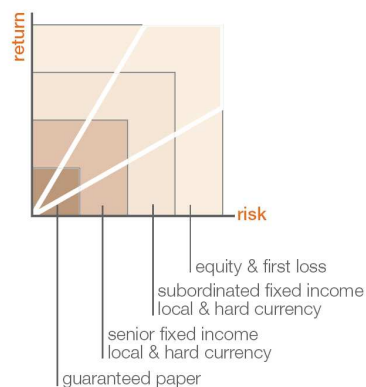
millions of micro, small and medium enterprises, the vast majority of which financed and controlled by local capital.

The UN 2005 year of micro-credit has largely contributed in opening up the investment market to the larger foreign private sector, and even to the capital markets, and forcing new players beyond the usual target group of MFIs. The World Bank has also been pushing for the integration of the local financial sector and the importance of local market development and infrastructure; they are promoting a move out of ‘microfinance’ and into ‘financial services for the poor’. Their real emphasis is now on building ‘inclusive financial systems’<sup>13</sup>; CGAP now believes that “up to three billion people seek access to basic financial services”, broadening yet even further the perspectives for the investor community.

Today balanced mutual funds constitute the new generation of investment vehicles grasping this new reality. They represent this change in the market away from direct lending in hard currency to a limited amount of foreign controlled programs and towards providing the full range of asset class products to financial service providers for the poor. They attract money from the public, face hundreds of microfinance institutions and buy equity, high yield direct local currency debt, subordinated loans, credit swaps, guaranteed notes, asset backed securities, securitizations, etc. Their managers diversify and balance their portfolio, positioning their fund somewhere on the risk/return curves of the market, depending on the strategy they elect for their investor clientele.

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**Figure 4: Balanced Mutual Funds**




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This essential change, from pioneering hard currency debt investments into professional and balanced fund management strategies has been possible by the recent appearance of market makers, investment bankers, brokers, product arrangers, investment servicers and other market intermediaries.

<sup>13</sup> Helms, Brigit; 2006 ; *Access for All : Building Inclusive Financial Systems*; World Bank, Consultative Group to Assist the Poorest (CGAP).

### 3.2.3 Brokerage and market intermediation

The growth in size and maturity of the microfinance investment market has among other things increased its transparency, competition and standard setting. These changes are bringing positive pressures on the industry, improving its efficiency and outreach – to the benefit of microfinance institutions and its clients. The development of track records and credit histories is also bringing a material change on risk management, pricing structures and intermediation margins as microfinance investors and institutions get to know their exact value and pricing expectations.

As the needs, actors and structures of the industry have increased in size and sophistication, microfinance investors' need for market information, ratings and evaluations, investment prospecting, negotiations and monitoring have increased as well. For many specialized funds and asset managers, the economics of developing an in-house comprehensive buy side analysis, brokerage and servicing team nevertheless contravenes with their own profitability bottom-line. Many have already started to seek better efficiency, profitability and risk management by outsourcing labour intensive and non core activities to specialized organizations.

Also as microfinance investments evolve towards a recognized investment opportunity, mainstream commercial banks, asset managers and traditional fund managers are increasingly interested in its investment vehicles - without desiring to develop a specific microfinance in-house competency. As they approach the market, they naturally look for advice and service opportunities. Adding to the usual brokerage and servicing mandates, they also look for structured finance and investment product setup expertise.

This evolution of the market has called for the creation of professional services companies meant to assist microfinance investors and fund managers in the achievement of their goals. These actors focus on market research and analysis, micro-banking relationship management and transaction structuring and placement. They invest in different capital and labour requirements and leverage their business by selling independently their services to an array of different investors and fund managers, which in turn benefit from lower cost and better quality investments.

### 3.2.4 Implications for the use of guarantees and guarantee funds

From the perspective of the borrower and its lifecycle, we know that guarantees are not useful for early stage institutions and become relevant as a collateral tool for lenders in the borrower's growth phase or as risk alleviation tool for mature microfinance institutions wanting to sell off of their balance sheet part of their asset risk.

What we can further conclude looking at recent market developments is that microfinance institutions in their growth phase do have access to large volumes of foreign incoming capital. They can also much better sell themselves (transparency, regulation, competition) to fund managers and thus often do not require collateral to access capital from foreign investors. On the contrary, funds managers are in demand for guarantee solutions to mitigate their risk on portions of their portfolios and investment brokers are in demand for guarantee solution to structure investments that fit the risk requirements desired by the fund manager clients. The changes in the market have opened up an entire new arena for guarantee products.

Also, and differently, the market tells us that the vast majority of capital provided to microfinance comes from local investors. Equity and savers don't require any guarantee, but local lenders do offer only secured debt and welcome guarantee collateral. Foreign funders also are increasingly using the liquidity surpluses of emerging market banks to push local currency to their target investees by providing such banks hard currency capital as collateral. Both foreign funds managers and investment brokers have found in the guarantee market a vast potential business. It seems as though more and more foreign capital will be most efficiently used by issuing risk alleviation tools to local currency capital, the local investor providing the funds and the foreign investors buying the risk.

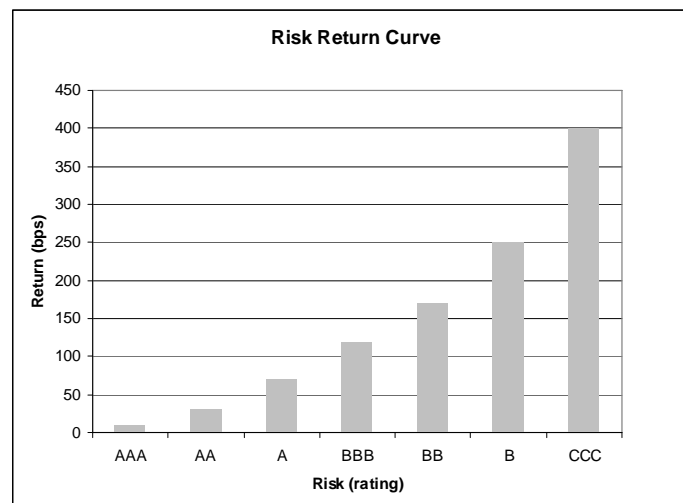
Finally, the guarantee fund manager, as the investment fund manager, faces a completely different industry than still five years ago, with an array of investment opportunities offered to him and an array of investment arrangers to which he can outsource all activities not linked directly to its core business of evaluating and pricing risk and buying it off of its client.

### 3.3 *Guarantees for Microfinance: Risk, Use, Products, Actors and Pricing*

#### 3.3.1 Risk and financial management

Basic financial management teaches us that capital has an opportunity cost, which determines its price; any capital allocated to a certain activity should yield a similar return to any other opportunity of similar risk. A finance manager will evaluate its assets in terms of risk and return opportunities, and will allocate its resources to opportunities meeting his strategy, somewhere along the risk / return curve of his market. He will implement his return strategy by positioning his activities in a certain category of risk.

**Figure 5: Example of a Risk Return Curve**



Similarly, his cost of capital will be determined by his activities, their risk and their equivalent rating. Equity holders or lenders will assess such loss expectations, based on such rating and require reward in function of the cost of such uncertainty and provisional measures.

Put simply, the price that the assets will yield is a function of their risk, and the cost of funding is a function of the institutional risk. Finance managers are into the business of extracting the rent between the yield of their assets and the cost of their funding, both a function of their risk.

A finance manager will need to excel in the art of risk management. Whether on the asset side or the liability side of his balance sheet, risk will depend on an array of dimensions or sub-categories of risk. Risk management is about identifying such sub-categories and achieving to forecast them with the highest level of certainty. Finance managers will seek risk alleviation tools, such as guarantees, to hedge dimensions of their activity for which the level of uncertainty is too high.

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**Figure 6: Expected Losses And Credit Risk (7 years)**

**Idealised Cumulative Expected Loss Rates**

Rating	1	2	3	4	5	6	7
Aaa	0.00000%	0.00000%	0.00000%	0.00000%	0.00000%	0.00000%	0.00000%
Aa1	0.00003%	0.00011%	0.00039%	0.00099%	0.00160%	0.00220%	0.00286%
Aa2	0.00031%	0.00165%	0.00550%	0.01155%	0.01705%	0.02310%	0.02970%
Aa3	0.00075%	0.00440%	0.01430%	0.02585%	0.03740%	0.04895%	0.06105%
A1	0.00166%	0.01045%	0.03245%	0.05550%	0.07810%	0.10065%	0.12485%
A2	0.00320%	0.02035%	0.06435%	0.10395%	0.14355%	0.18150%	0.22330%
A3	0.00598%	0.03850%	0.12210%	0.18975%	0.25685%	0.32065%	0.39050%
Baa1	0.02137%	0.08250%	0.19800%	0.29700%	0.40150%	0.50050%	0.61050%
Baa2	0.04950%	0.15400%	0.30800%	0.45650%	0.60500%	0.75350%	0.91850%
Baa3	0.09350%	0.25850%	0.45650%	0.66000%	0.86900%	1.08350%	1.32550%
Ba1	0.23100%	0.57750%	0.94050%	1.30900%	1.67750%	2.03500%	2.38150%
Ba2	0.47850%	1.11100%	1.72150%	2.31000%	2.90400%	3.43750%	3.88300%
Ba3	0.85800%	1.90850%	2.84900%	3.74000%	4.62550%	5.37350%	5.88500%
B1	1.54550%	3.03050%	4.32850%	5.38450%	6.52300%	7.41950%	8.04100%
B2	2.57400%	4.60900%	6.36900%	7.61750%	8.86600%	9.83950%	10.52150%
B3	3.93800%	6.41850%	8.55250%	9.97150%	11.39050%	12.45750%	13.20550%
B3	6.39100%	9.13550%	11.56650%	13.22200%	14.87750%	16.06000%	17.05000%
Caa	14.30000%	17.87500%	21.45000%	24.13400%	26.81250%	28.60000%	30.38750%

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### 3.3.2 Microfinance institutions and risk management

Similarly, MFI risk management will begin by developing risk management scorecards, including financial and non financial risk dimensions. Most non financial risks will be dealt with on a best practice basis and cannot be hedged through risk alleviation contracts; most financial risks theoretically can.

Financial risk stressing the balance sheet will mainly concern currency risk, maturity risk and interest rate risk. Generally, the MFI manager will limit such risk by respectively keeping

hard currency volumes higher on the assets than on the liability side of the balance sheet, keeping a longer weighted average maturity of its assets than of its liabilities and keeping the volatility of its interest rate spread as low as possible. Alternatively, more mature MFIs will seek to buy hedging contracts to limit currency risk and can similarly look into swapping their interest rate risk. In each case, MFI managers will not find in guarantees the right product to hedge such segmented risks.

➤ *Synthetic Securitizations*

Guarantees will be useful risk alleviation tools for MFI managers in instances where there is a need to restructure the asset side of the balance sheet, by improving the risk weight of portions of it. This will happen through entering into credit default swaps or portfolio guarantees, in effect insurance contracts, with insurance providers, whether funds or firms. Such insurance will partially remove the provisions for expected losses (fig. 6) and capital allocation costs (fig. 7) by increasing the asset quality of the institution, and consequently reduce as well their cost of funding.

Large and mature microfinance institutions can work with local banking authorities into recognizing credit default swap contracts on portions of their loan portfolio as providing a reduced risk weight to such portion of the assets, reducing capital requirements for regulated institutions. The financial risk management arena refers to such operations as ‘synthetic securitisations’ as the MFI is contractually selling the risk of its clients off to a third party while still keeping such loans on its books. These guarantees are powerful capital relief tools but remain rather limited due to the few number of such large, regulated and highly leveraged MFIs today and to the complexity involved in their setup.

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**Figure 7: Credit Risk Rating And Capital Allocation**

<b>Risk Grading</b>	<b>Capital Allocation</b>
Aaa	2.0%
Aa1	2.0%
Aa2	2.0%
Aa3	2.0%
A1	5.0%
A2	5.0%
A3	5.0%
Baa1	10.0%
Baa2	10.0%
Baa3	15.0%
Ba1	17.5%
Ba2	20.0%
Ba3	22.5%
B1	25.0%
B2	30.0%
B3	30.0%

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➤ *Guaranteed funding*

Guarantee products will also be used by MFI managers issuing debt products and not meeting risk expectations of their fund providers; either the MFI or the lender will seek to hedge partially or completely the transaction by selling part or all of its risk to a third party.

### 3.3.3 Banks, microfinance fund managers and risk management

Indeed banks and fund managers providing capital to microfinance institutions will have investment and credit risk guidelines. They will seek investment opportunities with risk return profiles matching their guidelines. The credit risk offered by microfinance institutions will often not qualify for their investment guidelines. Banks and fund managers investing in microfinance will thus face several strategies to by pass their risk guidelines while still providing capital to microfinance. Most or all will entail working with third party intermediary, structuring/wrapping a transaction to fit the investor's needs.

#### ➤ *Basic strategies*

Fund managers applying a basic risk alleviation strategy will solely seek to diversifying their investments as much as they can, atomizing their asset base and any impact of some of them defaulting. They will not seek guarantee products. Fund managers seeking simple solutions will also require security interest over part of the borrower's assets in case of bankruptcy, as risk mitigating collateral. Fund managers may also for instance require a client-investor asking for a particular investment to pledge his deposit with the fund manager as first loss cash collateral over all or part of the foreseen investment, referring to it as a guarantee deposit.

#### ➤ *Stand-by letters of credit*

Fund managers may also require a synthetic guarantee, rather than cash collateral, in the form of a stand-by letter of credit, promising reimbursement on behalf of a debtor to the benefit of a creditor, on a given transaction not meeting investment restrictions. Such letter may be conditional or unconditional, full or partial, and in the latter case subordinated or *pari passu*.

Synthetic guarantees will be useful for banks and fund managers for direct operations, lending to microfinance institutions with the benefit of a third party letter of credit. Increasingly, synthetic guarantees are also used for indirect operations, offering risk alleviation to securities sold to banks and fund managers so as to achieve their investment risk return expectations. Investment arrangers will thus be the client of such insurers when structuring their securities to be sold to banks and fund managers.

Guarantee funds prove the full extent of their value to such actors (commercial banks, investment vehicles and arrangers) customizing their guarantees to specific products and situations, and yielding the most value out of them.

### 3.3.4 Guarantee Product Examples

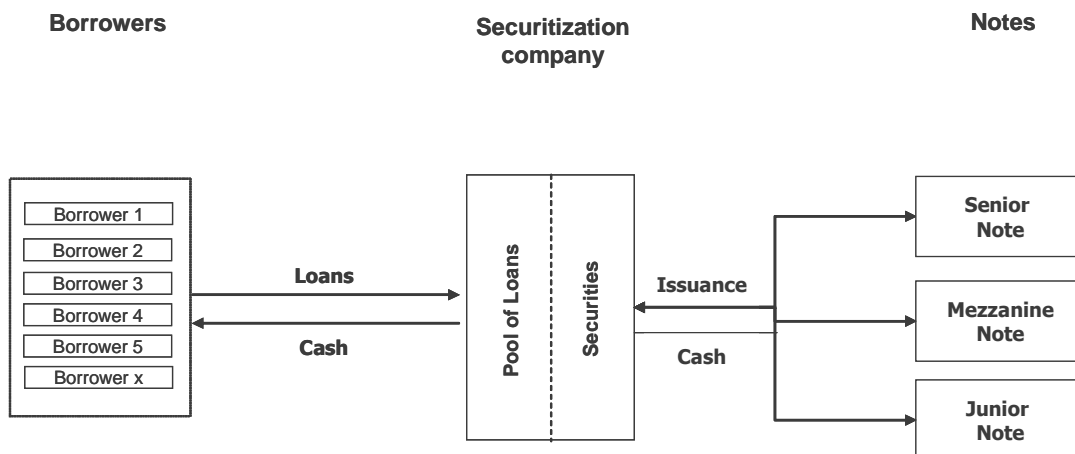
Synthetic guarantees can be used in many ways and appear all along the spectrum of investment products. Below are listed a few examples of recent and diverse transactions observed on the market integrating a guaranteed feature.

- **Cash collateral guarantee.** A five million Euro cash deposit in a local bank in Macedonia to be pledge as collateral for the making of a Macedonian denar loan to a microfinance institution.

- **Full pari passu guarantee on direct loan.** A letter of credit issued by a Luxembourg microfinance investment vehicle to the benefit of a Peruvian bank, as full collateral for the making of a six million Nuevo Soles loan to a microfinance institution.
- **Leveraged pari passu guarantee on direct loan.** A letter of credit issued by a Luxembourg microfinance investment vehicle to the benefit of a Moroccan bank, as partial collateral for the making of a loan to a microfinance institution.
- **First loss guarantee on direct loan.** A letter of credit issued by a US microfinance investment vehicle to the benefit of a Luxembourg microfinance investment vehicle, as partial first loss collateral for the making of a loan to a Balkan microfinance institution.
- **Senior note guarantee.** A thirty million Euro structured collateralized loan obligation for a Luxembourg microfinance investment vehicle meant to finance Eastern European MFIs, including a twenty million Euro full unconditional guarantee from a Luxembourg insurer on the structure's senior obligations.
- **Synthetic guarantee CDO.** A ten million dollar structured collateralized guarantee obligation for a Luxembourg microfinance investment vehicle meant as collateral for an Asian bank wanting full guarantee on their loans to local microfinance institutions.
- **Synthetic securitization.** A multi-million dollar credit linked notes issuance in Europe backed by credit default swaps buying micro-credit default risk off of a network of micro-banks in Peru.

### 3.3.5 Example of guarantee use in microfinance structured investments

A Collateralised Loan Obligation (CLO) transaction is a financial structure in which a pool of loans is refinanced in the capital market. For borrowers, a CLO financing transaction can be an attractive alternative to other types of financing and financial intermediation.



In such a CLO financing transaction, a group of borrowers seeks loan financing. The lender is typically a special purpose vehicle (e.g. a securitization company), which makes a term loan to each borrower. In turn, the lender of such loans (the securitization company) issues asset-backed notes, and uses the proceeds of such issuance to make the term loans. The investors in the asset-backed notes are paid interest and principal out of the cash flow generated by the term loans. Often, the asset-backed notes are issued in different tranches of seniority (i.e. of different risk/return profiles), matching the profiles of different investor types.

The application of such structures may offer the following advantages to the borrowers:

- (i) **Broadening of the investor base**  
Compared with a direct investment scenario, the investor base can be broadened significantly thanks to increased volume, enhanced diversification and more sophisticated investment type.
- (ii) **Reduction of costs of financing**  
Total costs of financing are often considered as attractive, thanks to three effects: First, such CLO financing allows to directly tap capital markets, which reduces further intermediation costs. Second, the passive nature of such CLO finance transaction eliminates management fees. Third, the structuring of the asset-backed notes in different layers may help to reduce the overall risk premium.

*Example structure and tranching:*

It has been discussed that the tranching of the asset-backed notes (i.e. of the liabilities of the special purpose vehicle / securitization company) is a core element and particular to such type of financing. The tranching of a specific transaction depends on criteria like diversification, volume, and required level of subordination. A microfinance CLO transaction closed by Symbiotics SA and the European Investment Fund in October 2006 had a tranching of approximately:

- Senior Note: ~ 70% of total notes nominal
- Mezzanine Note: ~ 25% of total notes nominal
- Junior Note: ~ 5% of total notes nominal

Senior notes benefit from subordination provided by the Mezzanine and Junior Note, meaning that any shortfall of cash-flow to the special purpose vehicle (e.g. in case of borrower default) will be covered in reverse order of seniority, i.e. first by the Junior Note, then by the Mezzanine Note, and ultimately by the Senior Note. In other words, a shortfall of up to approx. 30% of the scheduled amount will not affect investors in the Senior Note, which of course improves the credit risk rating of the Senior Note.

*Guarantee feature:*

Obviously, the credit risk of the Senior Note is relatively lower than the credit risk of the Mezzanine and Junior Note. Investors in the Senior Note are therefore investors that may have a relatively higher risk-aversion than other investors. In order to further enhance the attractiveness of such Senior Note for certain types of investors, it is possible to buy

guarantees (partial guarantees or full-guarantees, so-called “wraps”). Investors in such guaranteed notes are exposed to the risk of the guarantor, but less to the underlying credit risk. Depending on the type of guarantor, such guaranteed notes can be easily placed with institutional investors.

Coming back to the transaction described above, the Senior tranche was benefiting from a full guarantee (wrap) by the European Investment Fund, and placed as AAA-risk in the capital market, at terms reflecting the counterparty risk of the European Investment Fund.

#### *Guarantee pricing:*

Guarantees are not for free, as risk is being transferred. For such CLO transactions, the fee that is payable for a guarantee on a certain Note depends primarily on two elements: (a) the overall pool risk of all borrowers that are financed in the transaction, and (b) the level of subordination that is offered to the note on which protection is bought.

The overall pool risk consists of the core borrower risk and, specifically applicable in emerging markets, the country risk associated to the respective borrower’s country. The credit risk of a specific tranche is then basically a function of the overall pool risk, the assumed diversification in the pool and the level of subordination and other enhancements of the specific tranche.

The pricing of the guarantee is then in turn basically determined by the credit risk and maturity of the respective tranche. In the transaction described above, the credit risk of the underlying tranche has been of a ‘BBB’ equivalent (basically calculated as described above), and correspondingly the fee payable to the guarantor was based on such risk estimate. The pricing was thus determined by the market spread value at the time of closing between a BBB fixed income security and a AAA fixed income security. Each guarantee will thus find its pricing depending on investor and market demand on a given date.

#### 3.3.6 Guarantee Market Actors

Many players are working on many creative similar type transactions. There are specialized guarantee funds, but also microfinance investment funds, specialized securitisation companies, specialized government and multilateral programs and market intermediators. All can use their assets to back and guarantee a third party’s risk.

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This list is not exhaustive and excludes all local actors, commercial banks and financial institutions.

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### Figure 8: Microfinance Guarantee Market Actors

*1. Specialized microfinance guarantee funds include the International Guarantee Fund, as well as:*

- Accion Latin American Bridge Fund
- Appui au Développement Autonome
- Deutsche Bank Microcredit Development Fund
- Développement International Desjardins Guarantee Fund
- Grameen Growth Guarantee Fund,
- Opportunity Guarantee Fund,

*2. Specialized microfinance investment vehicles issuing and/or using guarantees include:*

- BlueOrchard Microfinance Securities I LLC
- Calvert Foundation
- Dexia Micro-Credit Fund
- Doen Foundation
- Dual Return Fund – Vision Microfinance
- DWM Securitisation SA
- Global Microfinance Facility
- Gray Ghost Microfinance Fund LLC
- Latin American Challenge Investment Fund
- Microfinance Loan Obligations SA
- Oikocredit International
- Oikocredit International Cooperative
- Triodos Bank microfinance funds
- World Vision – Vision Fund

*3. Public sector agencies focusing on microfinance using, arranging or issuing guarantee products include:*

- Agence Française de Développement
- Asian Development Bank
- Austrian Development Agency
- BIO
- Deutsche Entwicklungsgesellschaft
- European Bank for Reconstruction and Development
- European Investment Fund
- European Investment Bank
- FinnFund
- FMO

- Inter-American Development Bank
- International Finance Corporation
- Inter-American Investment Corporation
- Kreditanstalt für Wiederaufbau
- Multilateral Investment Fund
- U.S. Overseas Private Investment Corporation
- Swiss Investment Fund for Emerging Markets
- Swiss Development Cooperation
- Swiss Secretariat for Economic Affairs
- USAID DCA

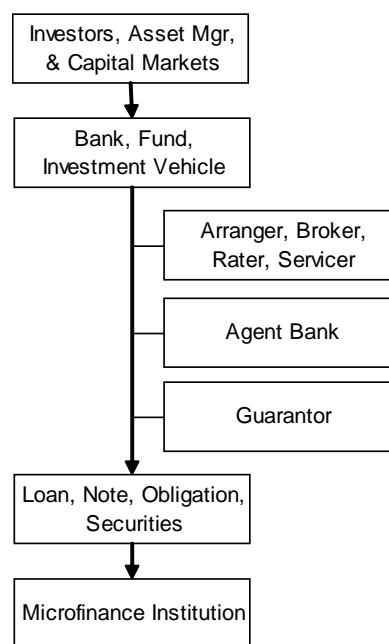
*4. Market intermediates using, arranging or issuing guarantee products include:*

- Alterfin
- BlueOrchard Finance
- Cordaid
- Cyrano management
- Developing World Markets
- Finca International
- Global Partnerships
- Grameen Foundation
- Hivos
- Incofin
- MicroVest
- Novib
- Omtrix
- Opportunity International
- Planet Finance
- Rafad
- responsAbility
- SOS Faim
- Symbiotics
- Women’s World Banking
- World Vision International

### 3.3.7 Guarantee business and pricing

Guarantee products for microfinance investments are a growing trend in a fast growing industry. Their value is increasingly clear and evident to foreign actors; guarantee products are essential pieces of the off-shore-fund-managers-and-capital-markets-providing-foreign-capital-to-local-often-non-investment-grade-microfinance-institutions equation. The guarantee business imbricates itself in the current microfinance investment value chain between the investment vehicle and the microfinance institution.

**Figure 9: Microfinance Investments Value Chain**



Its value has an equivalent cost, which has the advantage of theoretically not adding a cost layer to the value chain. The guarantee pricing will depend on the volume of risk that it buys off of the investor; contrarily to an agent bank and other intermediaries such price can be determined by the market and should not be the source of much negotiation. In such operations, the guarantor will determine the credit risk, usually based on external ratings, of the transaction originator, in this case the microfinance institution, and will look at market spreads between the current credit risk and the credit risk his investor-client wants to achieve (market pricing). Alternatively the guarantor will do a cost pricing, calculating the cost to his fund of provisioning expected losses and the rating capital allocation assumptions. Whether market or at cost, such pricing should not be pushed on to the microfinance institution as an additional cost but merely pushed in the existing interest rate, reducing in proportion the initial expected yield to the investor, now benefiting from a reduced credit risk accordingly priced.