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Fund Guarantees with Clear Exit Strategy: Donors Building the Confidence of Commercial Banks in Funding Microfinance Institutions

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ABSTRACT

This article explores the practice of donors providing guarantees to funds accessed by microfinance institutions (MFIs) from commercial banks in the hopes that they will continue lending to MFIs even without the guarantees. The goal is for the bigger, stronger, and more mature MFIs to graduate from the guarantee scheme so that the smaller and younger ones will also have the chance to use the guarantees and have access to commercial sources of funds. It asserts that at the onset, donors already need to decide a clear exit strategy – timeframe or milestones to be reached – for the fund guarantees extended to select MFIs. At the same time, the institutional capacity of the MFIs should be strengthened in order to ensure that in the long run they will be able to operate well, repay their loans from commercial banks on time, and reach and affect the lives of more poor people.

Access to commercial funds remains to be a major challenge that microfinance institutions (MFIs) face. Commercial banks tend to look at microfinance as a risky investment. To build confidence in microfinance, donors now embark on a risk-sharing mechanism by virtue of fund guarantees. Over time, it is hoped that even without guarantees commercial banks would still be willing to provide funds to MFIs. This graduation of bigger, stronger, and more mature MFIs from the guarantee scheme will enable the smaller and younger MFIs to use the guarantees and also have access to commercial sources of funds.

In order to achieve this, donors need to decide early on a clear exit strategy – timeframe or milestones to be reached – for the fund guarantees extended to select MFIs. The institutional capacity of the MFIs should be strengthened as well in order to ensure that in the long run they will be able to operate well, repay their loans from commercial banks on time, and reach and affect the lives of more poor people.

The Context of Microfinance Fund Sourcing

In developing countries where microfinance services are making headways in outreach and impact, MFIs are still constrained in leveraging the limited resources they have. In an article on guarantees, Finance for Human Development or FIG (n.d.) reports that MFIs and agricultural cooperatives in Africa and Latin America face serious difficulties when they apply for credit from banks. This remains to be the case as well as in other regions despite the obvious need of these institutions to obtain loans from commercial sources in their quest to be self-sufficient.

It is in this context that international donors now forge strategic partnerships with commercial banks so as to better leverage private investments for microfinance. Among others, the provision of guarantees for commercial funds to MFIs is one of the key services donors offer worldwide (Ledgerwood, 1998). In this scheme, a portion of the funds released by commercial banks to MFIs is guaranteed by donors. In the event that the MFIs fail to repay their loans to commercial banks, it is the duty of the respective donors to cover such payments.

Especially during the growth phase of MFIs, loan resources from commercial banks at market rates are essential. Khalid (2008) points out, however, that MFIs may need to have a guarantee backing at least some portion of their bank funding. A guarantee may be required by banks as a pre-condition before lending to MFIs.

Rationale for Fund Guarantees

> *"A guarantee fund can provide the organization's initial access to the formal financial sector, strengthen the organization's capabilities as financial intermediaries and provide important leverage in terms of lending capability."*
>
> **–** Calmeadow (Global Development Research Center, n.d.)

Instead of directly providing loans to the more established MFIs that attract private lenders and can already access commercial funds, donor money is needed more by MFIs that cannot. Moreover, rather than directly providing loans to such MFIs who are still unable to attract private lenders, donor money may be of better use as fund guarantees that can be leveraged against commercial funds. This way, more money can be raised for use of more MFIs. Although difficult to measure, fund guarantees are supposed to have additionality. This means that additional loans are made available to MFIs because of the guarantees provided to the commercial banks (Levitsky, 1997).

In addition to the guarantee itself, international donors also provide transaction expertise and credibility that enhance the commercial banks' perception of MFIs under the guarantee scheme (Flaming, 2007). The reputation of international donors adds value to the transaction, giving commercial banks more confidence in select MFIs.

More and more investors are also becoming interested not only in financial gains but also on social impact of their funds. Fund guarantees not only bring MFIs closer to commercial banks, but also provide an opportunity for investors to leverage their funds far beyond the value of giving a direct contribution to an MFI. This way, more and more poor people will be reached by much needed microfinance services.

The overarching goal of providing fund guarantees to select MFIs is for microfinance to generate more funds in order to reach more and more poor people. Flaming (2007) stresses that fund guarantees assist the microfinance sector in general by facilitating access of MFIs to commercial bank loans, leveraging the guarantor's capital and supplementing the collateral MFIs can offer, and facilitating local currency loans without exposing the guarantor to exchange rate risk. In addition to this, fund guarantee schemes also improve access to information. As donors and commercial banks work on guarantee schemes for MFIs, they also share expertise that can later on be used by other potential stakeholders in the industry.

Eligibility Criteria for Fund Guarantees

MFIs vary in track record, asset size, outreach, portfolio quality, and methodology. Given the vast number of MFIs all over the world and the limited size and number of fund guarantees, only a few MFIs have actually accessed commercial funds using the guarantees. Such schemes are still yet to reach more MFIs, especially the smaller and younger ones.

The usual requirement for MFIs to be eligible for fund guarantees is the demonstration of financial soundness. This means that an MFI should be able to pass or show potential on certain financial performance indicators, showing means of repaying its loans from commercial banks.

In the end, there should be a balance between keeping the guarantee fund safe and including more MFIs under the guarantee scheme. Too strict eligibility criteria may only finance the strongest MFIs and may exclude smaller and younger MFIs that need the guarantees more. Too lenient criteria for access to the fund guarantees may on the other hand endanger the health of the whole scheme and ultimately jeopardize the trust of commercial banks in microfinance.

Track Record of Fund Guarantees

The most notable guarantee fund remains to be ACCION's Latin America Bridge Fund. It is the first guarantee fund that catered to MFIs and such venture helped demonstrate to commercial banks that microfinance in Latin America is commercially viable (Lopez and de Angulo, 2005). According to ACCION, the first decade of operations was marked by high demand for guarantees by MFIs but over time such need among its affiliates declined. As envisioned, commercial banks later on developed confidence in ACCION's affiliates. After several years of receiving guarantees, commercial banks generally agreed to extend loans to select MFIs on unsecured basis. This graduation of select MFIs from the guarantee scheme serves as a successful model in building the confidence of commercial banks in microfinance. It is a positive indication of the sustainability of the relationship between the commercial banks and the MFIs even after their graduation from the guarantee scheme.

It is also important to note that since the creation of the Latin America Bridge Fund in 1987, no investor has experienced a loss in its principal or interest (ACCION International, n.d.). The Fund is seen as a vehicle by which socially responsible investors help strengthen the businesses of the entrepreneurial poor as well as the communities in which they live.

At the moment, other international organizations also offer guarantees so that MFIs can have access to commercial sources of funds. Finance for Human Development, Grameen Foundation, and Women's World Banking are among them.

Despite the growing interest in providing fund guarantees, we should note that such a scheme faces several issues. First of all, only a few MFIs would be eligible for fund guarantees. Given the vast number of MFIs in so many countries where microfinance needs to flourish and expand, picking a handful and enabling them to access commercial sources of funds necessitates that other MFIs are to be relegated on the side and wait for their turn to come. Secondly, guarantees usually come with fees that increase the financial cost of borrowing. This may have serious implications to the interest rates charged by the MFIs to their end clients – the entrepreneurial poor. Finally, the sustainability of guarantee schemes has yet to be studied well. Given that most guarantee schemes targeted toward MFIs are relatively young, keeping them operational in the long run is still to be seen.

The Need for Clear Exit Strategy

Donor interventions, whether financial or otherwise, should have a clear exit strategy. In a presentation to the European Partners for the Environment in Belgium, de Ville (2004) pointed out that guarantees should only be temporary. More importantly he stressed that the guarantee should not be considered as a standalone investment but rather as a process to strengthen the MFIs. Khandner (1998) shares the same belief when he reported that donors should emphasize among the MFIs they support that financial sustainability must be attained within a set period and that their support is not open-ended.

ACCION is likewise vocal with the need for an exit strategy when it comes to fund guarantees. Its Latin America Bridge Fund guarantees are designed to be temporary, with the end view of helping MFIs "graduate to capital unsecured by a guarantee once the lenders gained confidence in their creditworthiness" (Lopez and de Angulo, 2005). On the average, select MFIs have used the Bridge Fund guarantees for five years. Khalid (2008) stresses that once the MFI has already established a good working relationship with the commercial banks and has a proven track record of about a year, the security arrangements can then be revised. Hence, an agreement with the commercial banks and the MFI can be forged in a way that the decline in fund guarantees as percentage of the total loan value happens on a yearly basis.

An exit strategy can be strategically mapped out using a two-pronged approach – by adhering to a timeline, and by using milestones that must be attained at distinct stages of the relationship among the donors, the commercial banks, and select MFIs.

Revolving the Fund Guarantees for Use of Other MFIs

By progressively lowering the percentage of guaranteed funds released by commercial banks to MFIs over time, the amount freed up can be used to guarantee other MFIs, especially those that are younger and smaller. As Helms (2006) puts it, donors should focus more on the next generation of strong institutions.

As competitive MFIs grow, they usually find better ways to access funding than borrowing from commercial banks (Flaming, 2007). MFIs in some markets may be able to change their legal structure, enabling them to mobilize savings from the general public. Given this scenario, such MFIs may no longer need or want to use fund guarantees. Pearce (2001) challenges donors to start looking at providing strategic support to smaller MFIs given that the stronger ones have already moved to commercial sources of funds.

For first time loans, ACCION's Bridge Fund guarantees only up to 90 percent of the loan value, and for good reason (Lopez and de Angulo, 2005). This is to ensure that the commercial banks lending to MFIs also bear some risk in the process, encouraging them to monitor such MFIs more carefully. However, Latin America is an advanced region when it comes to microfinance. It already has successful microfinance models that enhance the palatability of MFIs to commercial banks. Yet even with this bright scenario, the Bridge Fund still covers up to 90 percent of the total loan value.

It is always ideal to have the commercial banks share the risk of the lending from the onset. Generally, the bigger their share means better position for the guarantee scheme and the donors that back it up. The reality that must be emphasized, however, is that even in Latin America where you can find big, strong, and mature MFIs, commercial banks still require up to 90 percent of the loans accessed from them to be guaranteed.

Hence, in countries where there is very low or virtually no confidence by commercial banks to MFIs, the fund guarantee may start at 100 percent. This means that at the start and only at this stage, all of the risks involved in lending to MFIs are borne by the donors. Risk-wise, this is just similar to lending directly to the select MFIs. Fund guarantees, however, are more advantageous since it builds the confidence of commercial banks in funding MFIs, which direct provision of funds does not achieve. Over time, however, this percentage should decrease until such a point that donors no longer guarantee the funds accessed by MFIs from commercial banks. Table 1 shows a sample scheme using this scenario.

Table 1. Sample 6-Year Fund Guarantee Scheme in Countries with Low Confidence by Commercial Banks in Microfinance

Year	**Percentage of Guaranteed Funds**	**Percentage of Funds without Guarantee**	**Percentage of Funds Accessed by MFIs**
1	100%	0%	100%
2	80%	20%	100%
3	60%	40%	100%
4	40%	60%	100%
5	20%	80%	100%
6	0%	100%	100%

Table 1 shows a sample fund guarantee scheme that uses six years as timeframe, which can be adjusted to a longer tenure to fit the context of the select MFIs, taking into account the country-specific conditions rather than just the regional perspective.

Providing 100% guarantees may raise the question of moral hazard – the fear that commercial banks will not screen and monitor properly which MFIs will get the guarantees. However, as Levitsky (1997) aptly points out, competent banks will exert much effort to avoid loan defaults in order to protect their reputation. Attention should also be given to the fact that appropriate screening and monitoring of MFIs for guarantees is a joint right and responsibility of the donors (guarantors) and the commercial banks. Such as in retail microfinance, what is important is that screening for the guarantee scheme must also be based on the willingness and capacity of the MFIs in repaying their loans from commercial banks.

In other countries where there is already palpable confidence by commercial banks to MFIs, such as in the Philippines, the fund guarantee may start at 50 percent. This means that right at the onset of the guarantee scheme there is already an explicit understanding between commercial banks and the donors that the risk should be borne equally by both parties. Finance for Human Development (n.d.) shares the same view. In its discussion about guarantees, it reported that an element of its bank guarantees is that they "do not cover more than 50 percent of the loans to the beneficiary MFIs." Based on the experience of ACCION on its Bridge Fund, on the average select MFIs have the guarantees for five years (Lopez and de Angulo, 2005). Nevertheless, the same principle of weaning holds true – that after a few years the guarantee should be removed. Table 2 illustrates this type of fund guarantee scheme.

Table 2. Sample 4-Year Fund Guarantee Scheme in Countries with Palpable Confidence by Commercial Banks in Microfinance

Year	**Percentage of Guaranteed Funds**	**Percentage of Funds without Guarantee**	**Percentage of Funds Accessed by MFIs**
1	50%	50%	100%
2	25%	75%	100%
3	10%	90%	100%
4	0%	100%	100%

Table 2 uses a four-year timeline for the guarantee scheme. This may also be adjusted to fit the context of the MFI being considered for the fund guarantees. Once again, it must be stressed out that a clear exit strategy is necessary for such scheme to work. If the fund guarantee is always present, then it forfeits its main objective of only building the confidence of commercial banks in microfinance. Over time, commercial banks must be convinced that providing funds to MFIs is a sound investment. It does not only provide opportunities to more poor people to improve their lives, but it also positively affects the bottom line of the bank.

In order for the timeframe to work, it is also essential that donors look at milestones to be achieved by the MFIs under the guarantee scheme. It has already been established that MFIs should first pass financial performance criteria before being eligible for the guarantee scheme. This information must be shared with the commercial banks. Transparency and increased flow of information are vital in continuously building the confidence of commercial banks in lending to MFIs. Over time, the financial performance of the MFIs should be maintained or improved. This means that the MFIs should be able to demonstrate better institutional capacity and financial achievements because of improved access to commercial funds. Three indicators of financial performance may be used – portfolio quality, financial sustainability, and efficiency (Rosenberg, 2009). These indicators may be tracked even on a quarterly basis, depending on the ability of the MFIs to produce accurate and timely financial reports.

Complementing Fund Guarantees with Capacity Building

Fund guarantees need to be successful. If MFIs fail to repay their loans to commercial banks, it will destroy not only the reputation of the individual defaulting MFIs but also the overall confidence of the commercial banking sector in providing funds for microfinance. Having financial performance criteria as eligibility requirements and tracking financial and social performance over time, however, may not be enough to ensure that MFIs under the guarantee scheme operate well. They need to build their institutional capacity and it is in this regard that donors can extend much needed support.

As Charitonenko and de Silva (2002) clearly point out, a vital role of donors is to build the institutional capacity of MFIs. They stress that this can be done by supporting the availability of local microfinance training courses and programs, and by providing opportunities for senior managers to be exposed to successful microfinance programs in other countries. Donors can also provide an excellent learning source for microfinance providers. Many donors have worked with specific institutions, in particular regions, and with certain approaches. Sharing these experiences with practitioners and other donors is extremely valuable (Lopez and de Angulo, 2005).

Based on actual experience, fund guarantees work well when coupled with capacity building. ACCION admits that ultimately, gaining access to commercial funds without a guarantee is a result of the quality of the institution and its development (Lopez and de Angulo, 2005). Credit guarantees could not help MFIs that were not developing their own institutional strength. Regardless of access to commercial credit, MFIs that suffered high levels of delinquency, high transaction costs, inefficient credit procedures, or inadequate controls would still have those problems.

Moving Forward

Microfinance sectors in various developing countries need support in order to flourish and reach far more poor people. Given that one of the major constraints MFIs face today is lack of access to commercial sources of funds, donors can address this finance gap by providing fund guarantees rather than directly extending loans to MFIs. This practice entices commercial banks to pitch in and hopefully, to eventually take over the role of providing funds for microfinance without the use of guarantees.

Donors have a great deal of power and responsibility given the resources they control. The challenge is for them to think and act strategically to reach more MFIs and maximize the impact of their support to microfinance. Donors need to be conscious that fund guarantees are a financial intervention that should be weaned out over time. A clear exit strategy must be mapped out early on, taking into consideration the local context of MFIs in developing a timeline and milestones to be met for the guarantee schemes.

In ensuring the enhanced confidence of the commercial banking sector not only among select MFIs but in the entire microfinance sector, continued strengthening of the institutional capacity of the MFIs must also happen. There is a call for donors to complement their provision of fund guarantees with support to capacity building. The enhanced performance of stronger and more mature MFIs will give opportunity to the next tier of MFIs to utilize the same guarantee scheme.

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