Case Study

USAID Development Credit Guarantees

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Introduction

The United States Agency for International Development (USAID)'s Development Credit Authority (DCA) provided partial credit guarantees to help underserved borrowers access financing services. Private lenders used guarantee agreements to extend financing to borrowers in new sectors and regions which enabled the mobilisation of local private financing to those who needed it most. By opening up local channels of financing, this mechanism empowered entrepreneurs in developing countries.

Obstacles in financing for small and medium-sized enterprises

Local small and medium-sized enterprises (SMEs) play an important role in developing local and national economies and providing important services for communities. However, they often struggle to obtain access to suitable financing services and support (USAID, 2020). Some of the reasons include the demand for high collateral, high-interest rates, and a lack of loan products. SMEs list the lack of access to finance as a major obstacle to making new investments and securing working capital (USAID, 2019).

Partial credit guarantee mechanism

Several countries have made Partial Credit Guarantee (PCG) funds a part of their strategy to mitigate the financing constraints of SMEs (Beck et al., 2008). These schemes aim to expand lending to SMEs by reducing the lending risk for banks or other financial institutions. Thus, a PCG fund is a mechanism that promotes risk transfer and risk diversification. Through a PCG, the issuer guarantees part of the loan repayment in case of default (non-payment of debt). In doing so, the risk for the lender is reduced. A PCG fund can also help diversify risk by guaranteeing loans across different sectors or geographic areas. Furthermore, there can be gains concerning information and technical aspects if the guarantor has better information about the borrower than the lender (Beck et al., 2008).

The USAID Guarantees operate in four different formats as shown in Figure 1 (USAID, 2006). They all include a private lender, a borrower, and a 50% loan repayment guarantee from USAID in case the borrower cannot repay its debt (default). The possible arrangements are:

- **Loan Guarantee**: is a guarantee on one loan between an identified lender and borrower.
- **Loan Portfolio Guarantee**: is a guarantee on a portfolio of loans involving one lending institution and multiple borrowers.
- **Portable Guarantee**: is a guarantee in which the lender is not identified. A letter of commitment is given to the borrower allowing them to shop around for the best loan agreement. Once the guarantee is agreed upon, the lender is identified, and the letter becomes a loan guarantee.
- **Bond Guarantee**: is a guarantee on corporate and/or sub-sovereign bonds. The guarantee enables the bond issuer to obtain a higher credit rating and access less expensive and longer-term credit.

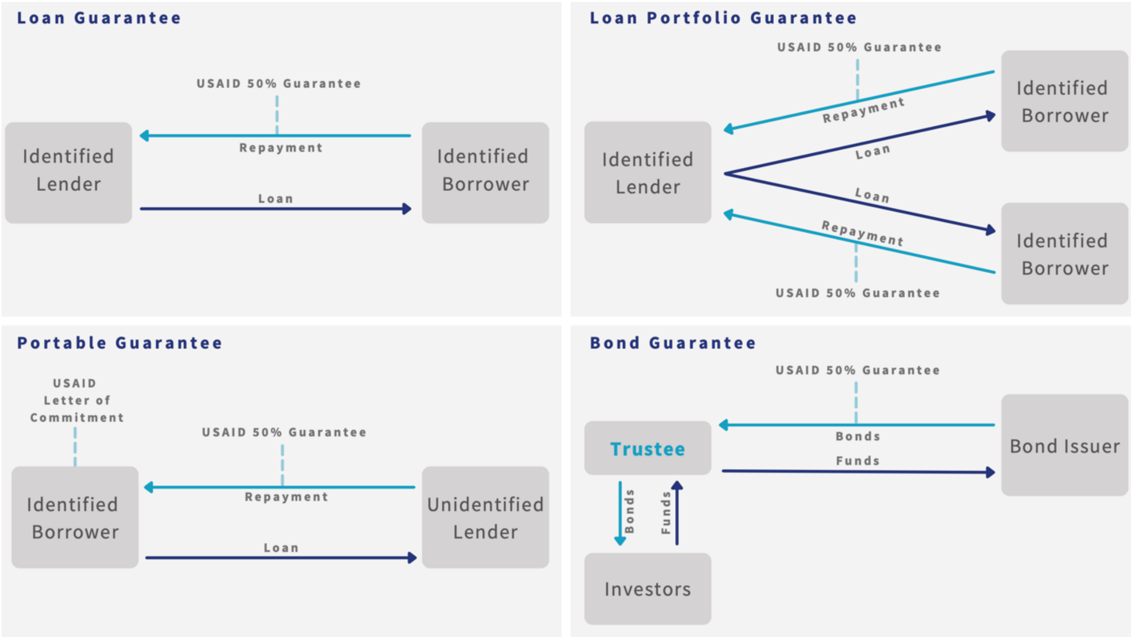

Figure 1 USAID's standard guarantee products. Source: Authors (adapted from: USAID, n.d.).

Guarantees aim to promote risk-sharing partnerships and additional funding for development in a sustainable way. First, the risk is shared by mobilising financial institutions that grant loans with their own capital. The cumulative default rate of all these loans marks only 1.85%, of which up to USD 3.1 billion were cost-effectively mobilised in private, local funds to finance development. Second, additional funding is mobilised because the guarantees allow for greater risk. This is done with either a new loan product, offering improved loan terms, or lending to a new sector. To avoid guaranteeing loans that banks would have made without the guarantee, USAID charges banks fees. Third, sustainability can be seen in the cases where banks continue lending to the same borrowers even after USAID guarantees expire. The PCG is designed to make sure that banks perform their own due diligence. That way, they understand new sectors better and are thus more likely to continue lending on their own. The success of USAID partner banks has further made the competitor banks aware of this market.

Development Credit Guarantees in Education

Private education in Ghana

Between 2009 and 2016, a DCA agreement with Opportunity International Savings & Loans (OISL), saw USD 2.5 million of loan guarantees for the construction and expansion of unregistered private schools (Kipnis, 2013). OISL, a regulated, non-bank financial institution, was motivated to partner with USAID through its desire to hedge the risk of entering a new market and its social mission of transforming lives. As well as absorbing some of the risk for OISL, USAID enabled these private schools to access formal credit financing with a 50% risk-share of potential net losses on principal.

The project saw OISL disburse over 290 DCA-guaranteed loans, of which approximately 82% was dedicated to school construction including, replacing wood infrastructure with cement for Ghana's hot climate, expanding the number of classrooms and other building facilities (libraries, toilets, kitchens, libraries etc.) (Kipnis, 2013).

US International Development Finance Corporation

In 2019, USAID's DCA merged with the Overseas Private Investment Corporation (OPIC) to establish the US International Development Finance Corporation (DFC), which aims to strengthen and modernise American development finance.

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