Evaluation brief

EVALUATION OF SIDA'S USE OF GUARANTEES TO PROMOTE MARKET DEVELOPMENT AND POVERTY REDUCTION

Guarantees positively contribute to private sector development and the development of financial markets. In cases where financial intermediaries are not able to lend to clients because of the risks involved, guarantees can bridge the risks and allow intermediaries to reach out to clients that could otherwise not be served. When it comes to overcoming the weaknesses of the financial markets overall, the guarantee is an important instrument but it is not sufficient on its own. These are two of the main conclusions of the evaluation of four guarantee interventions of Sida.

Purpose was learning

Sida has used guarantees for approximately ten years and currently has close to 35 on-going guarantees. This is the first evaluation of this instrument and its purpose was to deepen Sida's knowledge of the instrument and to draw lessons of broader relevance from a limited number of interventions covering different types of guarantees, partners and time periods. It presents conclusions and lessons on which instruments work to promote market development and reduce poverty, and which don't, in different circumstances. The evaluation is based on Sida documents, interviews with Sida staff as well as four case-studies; two in Uganda, one in Bosnia and Herzegovina and one global intervention.

Four types of common guarantees for achieving development impact:

- A **loan guarantee** involves guaranteeing a loan between identified lenders and identified borrowers.
- A **portable guarantee** is a letter of commitment which enables a borrower to approach a financial institute and to negotiate more favorable terms.
- A **volume guarantee** is an agreement that buyers make with suppliers in regards to purchasing a minimum volume of products or services. This is often combined with a low supply contract that determines the prices of future deliveries.
- A **loan portfolio guarantee** is a guarantee that collects several investments or loans in one portfolio.
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The optimal use of guarantees is that there should be a demand for the products the guarantee is expected to cover

It is needed to keep in mind that a guarantee may be necessary, but it is never a sufficient instrument - that is, it cannot stand on its own. Without a given demand for investment credits there is also no demand for guarantees as these are used to enable investments that might be too risky for investors. The demand for guarantees is dependent on the turnover and profit expectations on the side of the ultimate borrower. This leads to a paradox - the better the economic situation, the more the guarantee is likely to be used as more investments will be considered. This in combination with the risk-awareness that is typical for financial institutions puts a strain on the additionality of a guarantee.

The guarantee is more likely to be used where a country shows growth or is recovering from a recession or otherwise have an investment climate that offers opportunities for small and medium sized enterprises. The evaluation confirmed the importance of using the guarantee instrument for attracting investors to invest in new markets. The following needs to be considered:

- Is the guarantee additional from a development perspective? Does it result in additional financing that is not otherwise available in the market?
- Is it important to create an additional source of financing from a diversification point of view? For instance to engage two banks or more banks to stimulate competition.
- It is important to ensure that the structures created benefit the ultimate development purpose and do not just benefit the fund manager and/or the recipient of the guarantee.

A guarantee can be more beneficial for promoting and stimulating the private sector in developing countries since providing grants and subsidies to finance companies and commercial activities often creates unfair competition. An over-dependency on subsidies can also hamper the private sector to compete internationally in the long-run. It is important that the local environment, and in particular the status of the financial sector, is well analysed to ensure maximum effect of guarantees.

Guarantees should be applied to borrowers who are in essence good entrepreneurs and have viable business plans, but who lack security for a regular credit

To maximise pro-poor market development there are a range of considerations this evaluation proposes. Loan criteria and compliance are two important elements to consider. In the case of portfolio guarantees it is essential that banks and Sida agree on the profile of the borrowers and the loans guaranteed. Guarantees should be applied to borrowers who are in essence good entrepreneurs and have viable business plans, but who lack security for a regular credit. Ideally when considering cooperating with banks they should show a certain pipeline of applications, or a list of recent rejections that fit these criteria. It would be beneficial if a certain share of the guaranteed amount were reserved for first-time borrowers. Care should be taken to ensure the selected bank has a branch network in the areas where the target group reside.

It should be expected that there will be some future claims on any guarantee. It is a matter of using solid credit assessment methods to ensure that this risk is manageable. It is also important to check that a country's overall regulatory situation is in line with what one wish to achieve with the guarantee. For example, in most cases the guarantee should be considered full collateral to substitute for the collateral otherwise demanded from the borrowers.

Technical assistance (TA) can be an important instrument to improve effectiveness and impact of a guarantee. An example of this is that the bank refers borrowers to a TA provider to strengthen some elements of business performance. However, then the TA provider needs to be sufficiently equipped and professional to warrant the trust of the bank and its client. Another example is to use TA to strengthening the awareness of the guarantee by the bank's loan officers so they understand the conditions of the guarantee and are able to identify clients and their financial needs. It is better to search for proven TA providers that are properly vetted and trusted by enterprises and the banking community rather than setting up new providers.

Guarantees carry a lower risk of market distortion than grants or loans provided by donors

Market distortion was not observed in the case-studies used in this evaluation, but this does not mean that there is no such risk. However, generally, guarantees carry a lower risk of market distortion than grants or loans provided by donors, as they do not directly fund projects or companies but 'merely' decrease the risk of transactions for the financial intermediaries involved. Making the guarantee available more broadly avoids unfair competition as long as the banks are all active in the specific field. The banks also have to be able to access the guarantee and pay a fair price for using it. The price should be set at a level which makes it attractive (and affordable) for borrowers.

A guarantee is a market and demand-driven instrument, so ultimately Sida has limited influence on the real use. It is therefore important to monitor the use and be prepared to act if the guarantee is not used optimally and for example phase out that specific bank so the guaranteed amount can be made available to other banks. It could also be beneficial if the bank is allowed to set its own variance on how much it wants to guarantee a specific loan, applying higher percentages for riskier loans and lower for less risky. This might serve additionality and also a larger number of borrowers could be reached. Pricing of the guarantee is important and it is a balancing act between charging enough from the banks so they don't consider it to be free and at the same time take into account appropriate risk while making sure that the costs for the guarantee are affordable for the ultimate borrowers. So if there is a subsidy, and depending on the nature of the guarantee, it should be ensured that the subsidy benefit the ultimate beneficiaries (the borrower), not the intermediaries (the bank) implementing the facility.

Cooperation between the Unit for Loans and Guarantees and those responsible for implementing strategies is very important

Coordination and ownership are crucial for making sure that guarantees are used effectively and efficiently within Sida's different strategies (how cooperation is conducted with individual countries and in different areas of work is described in strategies decided by the Swedish government). Cooperation between the Unit for Loans and Guarantees at Sida and those responsible for implementing strategies is very important. It requires that all relevant Sida staff understand when it is beneficial to use the guarantee instrument, especially in combination with other interventions that could enhance development outcomes. Even though guarantees have been used for more than ten years at Sida it has taken many years to learn and develop knowledge on how to best use the instrument. It can therefore be considered a "newer" form of modality. It may also be noted that guarantees may be necessary for longer stretches of time in order for banks to remain interested in lending to less secure small and medium enterprises (also in countries with a developed financial market, guarantees are used by governments to induce banks to lend, e.g. to new businesses).

Monitoring and evaluation

Coordination and ownership are crucial for efficient monitoring of guarantees. At Sida, the Unit for Loans and Guarantees is different from the rest of Sida and working with guarantees is different from working with grants as it requires different decision making and monitoring systems and procedures. Financial and development effects overlap and impact is first and foremost measured on the level of the financial intermediary and borrowers. To enhance the use of guarantees as one instrument to be used to achieve the goals set out in strategies will lead to better monitoring and evaluation of development effects and systemic changes. In many of the guarantees, Sida has worked closely with USAID which has contributed to Sida's learning. Sida also benefitted from their solid monitoring systems. The monitoring can however be improved by a stronger cooperation between those responsible for implementing strategies at Sida especially Sida staff in the embassies and the Unit for Loans and Guarantees.

Sida Evaluation 2016:1 Evaluation of Sida's use of guarantees for market development and poverty reduction and 2016:1a Case studies for the Evaluation Report

The evaluation was commissioned by Sida and carried out by Hans Slegtenhorst (team leader), Mart Nugteren, Alwin de Haas, Marie Heydenreich, Rien Strootman, Paulo Luswata, Nino Serdarevic, Anders Grettve and Bart Schaap from Carnegie Consult and associates between November 2015 and June 2016.
The evaluation and the report with case studies can be downloaded from
www.sida.se/publications