Financial Interventions to Increase Access to Commercial Credit In Developing Economies

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Resilient, well-functioning and vibrant financial systems are essential for financial and macroeconomic stability. Financial sector development leads to increased investment, economic growth and household incomes. Access to financing in developing economies, however, is often limited, even for creditworthy borrowers. Despite high lender liquidity in many economies, commercial credit is hampered by risk perception, deficient risk analysis and conservative credit policies.

Several financial interventions can be used to increase access to commercial credit for underserved sectors and borrowers. These include: (a) interest rate buydown; (b) co-financing; and (c) credit enhancement (guarantees). An intervention that offers a risk-sharing mechanism may be an effective tool both in increasing access to financing for underserved sectors and leveraging the underutilized local financial sector resources.

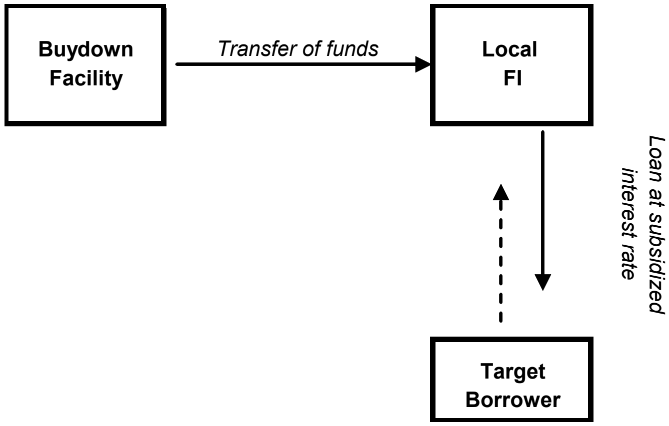
This memorandum discusses financial interventions that offer risk-sharing and leverage local private capital, increasing access to commercial borrowing for target beneficiaries. The memorandum discusses the advantages, disadvantages and structure of each intervention. The memorandum is intended to provide a basis for decision-making. The appropriate interventions for specific cases, their structure and cost should be examined on a case-by-case basis. Table 1 (page 6) summarizes the three types of risk-sharing interventions, as well as the structuring and funding options.

Types of Financial Interventions

Interest Rate Buydown

Interest rate buydown is a subsidy arrangement that allows a local financial institution (FI) to charge a lower interest rate to the borrower, while earning a market return. The buydown can be structured on a temporary or permanent basis. A temporary buydown, phased out gradually, is an initial lump sum paid by a third party (usually a donor) to reduce the borrower's monthly payments during the early years of the loan. A permanent buydown is a flat interest rate subsidy that reduces interest rate over the life of the loan (Chart 1).

Chart 1: Permanent interest rate buydown



The buydown facility can be structured as a separate entity that mixes its funds with the implementing FI to offer a permanent buydown, or as a deposit fund with the implementing FI, where the interest revenue is used to offer a temporary buydown. Buydown is appropriate when market interest rates are high and the borrower's cash flows are insufficient to support debt service. The intervention is frequently used in housing finance and the energy sector.

> **Interest Rate Buydown in Housing Finance**
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> Interest rate buydown can be used to help borrowers meet the cash flow requirements of a market rate mortgage. Buydowns are utilized in Scandinavia, as well as Hungary and Russia. Buydowns address the liquidity constraint by lowering the initial monthly payment burden on the loan. Compared to a flat interest rate subsidy over the life of a loan, buydown may be an efficient way to address the liquidity constraint because it takes into account that most borrower incomes raise over time. However, some research indicates that buydowns are not as effective as intended in assisting first-time home buyers who lack savings for down payment. These findings underscore the importance of ensuring that any risk-sharing interventions are situation-specific.
> *(Sources: Housing and the Macro Economy, by Urban Institute, April 1999 and Potential Effects of Mortgage and Subsidy Programs on Housing Affordability, by Urban Institute, et al)*

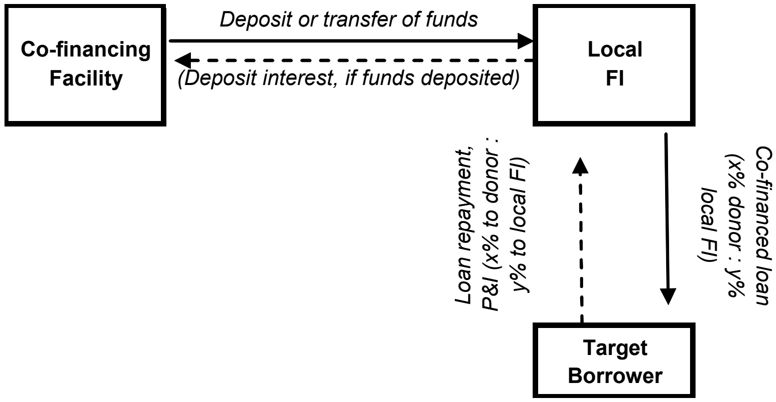
The risk-sharing feature of the buydown allows local FIs to offer financing to more risky, but socially important sectors, which still earn commercial market returns. The key advantage of a buydown for the target beneficiary is the reduction of the cost of debt service and the alleviation of the cash flow constraint, especially in the early stages of the life of the loan.

A potential disadvantage of a buydown facility is the complexity of administration, especially when the buydown involves several options of different depths (interest rate reduction) and/or lengths (number of years). Further, if the buydown is structured inappropriately and the increase in debt service payments at the end of the buydown is greater than the relative increase in borrower's income, the buydown facility may lead to higher defaults at the end of buydown. And finally, buydown fails to address lender's perception of the riskiness of the target borrowers, which may result in low utilization of the facility.

Co-financing

Under the co-financing approach, donor funds are transferred to or deposited with a FI selected to participated in the co-financing program, and used for joint financing of target beneficiaries (Chart 2). Generally, the bigger the proportion of risk undertaken by the partner FI, the lower the potential moral hazard and the higher the impact of commercial credit mobilized.

Chart 2: Co-financing



Assuming a *pari passu* relationship, a co-financing fund would collect a proportional share of interest revenues and absorb loan losses, respectively. Reflows from interest revenue and deposit interest (if the funds are deposited) could be used to offset the overhead costs and replenish the fund.

The key advantage of risk-sharing through co-financing is the ability to address lender's concerns about the riskiness of the target beneficiaries. Another advantage is the potential for replenishment of the fund through principal repayments, interest and deposit (if funds are deposited) income. However, if weak projects are chosen and/or operating costs are high relative to income inflows, the facility could deplete rapidly.

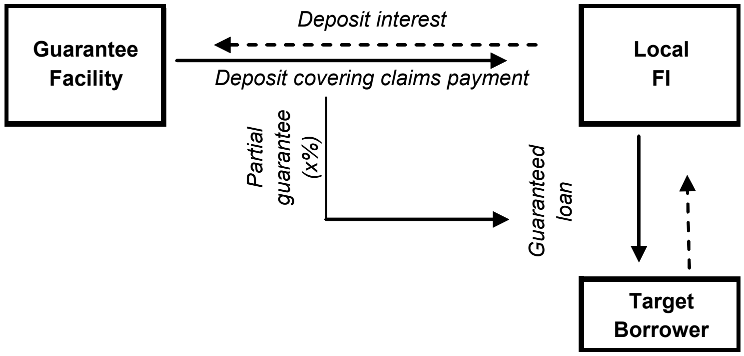
Commercial Co-financing by ADB

In 2003, the Asian Development Bank (ADB) mobilized about $2.4 billion in co-financing from the public, private and other donor sources, raising an additional 40 cents for every dollar in ADB funding. ADB offers commercial co-financing programs under two schemes: parallel financing and complementary financing. Parallel co-financing is by far the more prevalent structure, whereby a commercial term loan is arranged in parallel with ADB's loan (similar to the structure described in Chart 2). Although ADB co-financing focuses on large projects in the power, infrastructure and industry sectors, the two schemes may be equally applicable to smaller projects.
(Source: www.adb.org)

Credit Enhancement (Guarantee)

Credit enhancement, usually in the form of partial guarantees, is a cost-effective risk-sharing intervention capable of leveraging large amounts of domestic commercial credit for underserved sectors. Most commercial credit guarantee facilities are structured as contingent obligations of the guarantor (donor) toward the guaranteed party (local FI) to cover loans to target beneficiaries or projects. Alternatively, a guarantee can be structured as a guarantee fund, held in deposit with the partner FI, and used for claims payment (Chart 3).

Chart 3: Credit guarantee fund



All major donor organizations offer commercial risk guarantee facilities. One of the most successful commercial credit guarantee programs is USAID's Development Credit Authority (DCA) program. DCA is USAID's partial guarantee tool that allows USAID Missions to provide a local partner FI with guarantees for lending to target sectors and beneficiaries. The cost to the Mission is a one-time "subsidy cost", priced on the basis of the project risk factors. Fees are paid by guaranteed banks for the usage of the facility. As of July 2004, the DCA facility had mobilized approximately $780 million in commercial credit for underserved sectors, with the ratio of donor cost to total facility amount of 1:33.

Similar to co-financing, a credit guarantee serves to address the lender's concerns about the riskiness of the target beneficiaries. If the lender has sufficient liquidity, i.e., has ample loanable funds, it may prefer a guarantee to co-financing. The disadvantage of a guarantee is that the facility fails to address borrower concerns (e.g., high interest rates and/or collateral requirements) that may potentially hamper full utilization.

USAID DCA Loan Portfolio Guarantee for Microenterprise in Mexico

A $2.5 million DCA partial guarantee (on defaulted principal loss) was extended to FinComún, a microlender in Mexico, to cover loans to local microenterprises. The DCA guarantee stimulated the growth of market-based lending to Mexican micronterprises and demonstrated the existence of a large, profitable market for these services. The credit program facilitated the generation of over 18,000 new microloans over the three years of the life of the guarantee facility.
(Source: www.usaid.gov)

Facility Structure and Funding Options

The risk-sharing facility could be structured as a revolving or non-revolving fund.

A non-revolving facility requires a one-time allocation of donor funds, either a grant or a soft loan (or a subsidy cost contribution in the case of USAID's DCA guarantee). The funds could be transferred to or deposited with the financial institution selected to administer the facility and used for any of the three types of interventions. The leverage and impact of the facility will vary with the donor proportion of risk sharing.

A non-revolving facility is relatively simple, straightforward and easy to set up. The key drawback of a non-revolving facility is that the funding amount is finite and the long-term impact of such a facility may be limited.

A revolving facility is structured so that funds received from loan repayments are used to make new loans. Generally, a perpetual grant (or a long-term interest-free loan) is required to capitalize a revolving facility, and the grant capital cannot be diverted from the fund. The U.S. State Revolving Funds program created via grant capitalization in the late 1980s for water/wastewater financing is a good example of a successful revolving facility. If a donor wishes to create a revolving structure, at least a portion of its funding should be designated as grant equity capital.

The advantage of a revolving facility is its sustainability and long-term impact: a one-time grant can generate financing over extended periods, assuming it is properly managed. The key disadvantage is that a revolving facility tends to have a more complex legal structure and require higher upfront funding, so the advantage should be balanced against budget constraints and the administrative effort.

Table 1: Summary of Structure and Intervention Options for a Commercial Credit Risk-sharing Facility

By Intervention			
Intervention Type	*Risk Addressed*	*Advantages*	*Disadvantages*
Interest rate buydown	Insufficient borrower cash flows	Lowers interest rate/loan payments for borrowers	Fails to address lender's risk perception Potentially complex to structure and administer
Co-financing	Lender's risk perception	Mitigates lender's perception of borrower risk Potential for replenishment through reflows	Rapid drawdown if risks improperly assessed
Credit enhancement (guarantee)	Lender's risk perception	Mitigates lender's perception of borrower risk High ability to mobilize local capital relative to cost	Fails to address borrower concerns (e.g., high interest, collateral requirements, etc.)

By Facility Structure			
Facility Type	*Type of Donor Commitment Required*	*Administrative Structure*	*Impact*
Non-revolving	Soft loan or grant	Simple	Short-term
Revolving	Grant	Complex	Long-term