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Loan Guarantees and Financial Inclusion in the Developing World

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An entrepreneur in Guatemala works on her loom. She received support from Friendship Bridge, a client of MCE Social Capital that provides impoverished Guatemalan women microfinance and education services, 2013. (Courtesy Friendship Bridge)

Emerging Voices features contributions from scholars and practitioners highlighting new research, thinking, and approaches to development challenges. This article is from Gary Ford, chief executive officer of MCE Social Capital, and Benjamin D. Stone, director of strategy and general counsel of MCE Social Capital and a CFR term member. Here they discuss how loan guarantees can help unlock economic opportunities for people in the developing world.

According to the World Bank's 2015 **Global Financial Inclusion Database**, more than 2 billion people lack access to formal financial services, including savings accounts, insurance, and loans. Over the last two decades, microfinance has helped fill this gap by delivering credit and other financial services to low-income people, particularly entrepreneurs, around the world. As **studies show**, microfinance helps people build assets, manage risks and unpredictable income, and gain the freedom to decide how to make money. International NGOs, large financial institutions, government agencies, and individuals have all supported microfinance institutions with millions of dollars in grants, equity, and technical assistance. Notable in this context is the use of loan guarantees.

Loan guarantees—where a third-party pledges to assume the debt obligation of a borrower—have helped people access otherwise unobtainable capital since at least early roman times. Today, many organizations like **Accion International**, **Grameen Foundation**, **Shared Interest**, and the **United States Agency for International Development** (USAID) similarly use loan guarantees to help microfinance institutions (MFIs) secure capital and prove their creditworthiness. Here is how it sometimes works: organizations like the ones listed above receive grants (or loans) from individuals or foundations in the United States. Then, working through an international bank, they use the money to back loans MFIs borrow from local banks in the developing world. The MFIs then use this money to finance microloans and other services for people living in poverty. Ultimately, the MFIs are responsible for paying back the local banks, but if they don't, the organization, through its international bank partner, repays the local bank using the donated or loaned capital. In this way, loan guarantees can help poor communities in developing countries access money and financial services.

MCE Social Capital (MCE), a U.S.-based nonprofit impact investing firm that lends directly to MFIs, innovates on this approach. Instead of upfront contributions, MCE collects pledges from foundations and individuals (its "guarantors") to make tax-deductible contributions to MCE if (and only if) a MFI fails to repay the MCE loan. MCE pools these pledges—now over $100 million from 85 guarantors—and uses them as collateral to borrow from U.S. financial institutions, including **First Republic Bank**, the **Overseas Private Investment Corporation** (OPIC), and **New Resource Bank**. After a thorough due diligence process, MCE then lends to MFIs serving rural women in more than thirty developing countries.

MCE's loan guarantee model diversifies the funding of MFIs by unlocking capital from U.S. financial institutions that do not typically lend MFIs money. And by soliciting pledges rather than actual upfront contributions, MCE's guarantors retain and continue to earn returns on their capital. With loan default rates at 0.03 percent and the risk distributed across the pool of pledges, a guarantor can facilitate millions of dollars of lending at a relatively small cost. For example, a guarantor who signed MCE's pledge in 2006 has enabled nearly $3 million in loans into the developing world, all while making only $12,000 in tax-deductible donations to MCE.

To date, MCE has funded more than 400,000 microloans and other services (health programs, insurance, savings accounts, and business training) worth more than $160 million, reaching hundreds of thousands of people. MCE is now exploring opportunities to use its loan guarantee model to tackle other market gaps, including the lack of small and medium-sized enterprises (SMEs) financing in sub-Saharan Africa, where nearly half of SMEs report lack of money as the **biggest constraint on operations and growth**.

For thousands of years, loan guarantees have given hesitant lenders comfort to invest in potentially risky borrowers. MCE and other organizations are now adapting this mechanism to help more people and businesses across the developing world access capital and financial services.