Concept Paper for DCA Evaluations

USAID has hired Segura (with MSI as sub-contractor) to evaluate several Development Credit Authority (DCA) credit guarantees that have been structured since DCA's founding approximately ten years ago, to measure the development impact of the partial credit guarantees. This concept paper will explain the framework under which credit guarantees are designed and explain the expected results of a guarantee.

The Development Credit Authority is a tool that USAID missions and operating units can use to guarantee up to 50% of default on loans that support a developmental objective. These guarantees are backed by the full faith and credit of the US Treasury, and as such are an effective way to mobilize existing local financial resources. Banks in developing countries have excess liquidity, but are extremely risk-averse and invest in safe investments such as government securities. Businesses in developing countries, on the other hand, often operate in the informal sector and do not use formal business plans or cash flow projections to effectively market themselves to lenders. Therefore, borrowers in developing countries often face difficulties in accessing the credit needed to grow their businesses. Credit guarantees address this market imperfection, encouraging banks to make loans to unfamiliar but profitable sectors or geographic regions. It is expected that once lending institutions become familiar with these new borrowers, they will continue to lend after the guarantee has expired. Other expected results include a more dynamic and competitive credit market, as partner financial institutions demonstrate to non-partner institutions the viability of underserved sectors and consequently enter the market. Finally, it is expected that a credit guarantee will enable underserved borrowers to continue to access credit at market rates once the guarantee expires, since they will have established a credit history and proven their marketability to lenders.

The success and overall impact of credit guarantees depend on many variables. It is the goal of USAID that the effects of a guarantee will be sustainable, but sustainability depends on several factors beyond the guarantee itself. In discussing sustainability, USAID hopes to see the desired outcomes of a guarantee continue after the guarantee has expired; specifically, that banks continue to lend to the targeted sector, and that borrowers can continue to access credit at market rates. This indicates that the bank has used the guarantee to discover new borrowers that are creditworthy and profitable. How far-reaching these outcomes are (for example, whether it was only the partner bank or, by contrast, other competitors, that lend to a targeted sector) is further developed in the next section entitled "Levels of Results." Before that, though, it is necessary to explore the contextual framework in which a guarantee is designed, to highlight the fact that a credit guarantee's impacts are affected by many other factors that influence financial markets in developing countries.

The Framework

The initial impetus for a DCA guarantee often comes from a USAID mission that recognizes that access to finance is a necessary component of a technical assistance program. While it is sometimes the case that a credit guarantee is developed without any technical assistance, it is much more common that the mission is interested in using the guarantee to complement an ongoing technical assistance program. Once the initial idea has been proposed by the mission, the guarantee is then designed in partnership by both the mission and by USAID's Office of Development Credit in Washington. There are several factors that play a role in the impacts that the guarantee will effectuate.

First and foremost, the country's macroeconomic and regulatory environment will have a large role in how much impact a guarantee has on current and subsequent lending behavior. For example, a credit guarantee may be designed to lower collateral requirements, but if there is no credit bureau or property registry, then a lack of verifiable information about potential borrowers will often result in over-collaterization. Similarly, while another possible outcome of a credit guarantee is lower interest rates, banks are subject to the interest rates charged by central banks for their own loans and as such will not bring interest rates charged to clients below the spread they need to make a profit. Experience has taught USAID that when the macroeconomic and regulatory context is favorable, credit guarantees can have lasting and favorable impacts on bank behavior.

Secondly, credit guarantee impact is affected by technical assistance aimed at three broad targets: lenders, borrowers, and the enabling environment. USAID missions often implement a credit guarantee as a way to complement ongoing technical assistance to lenders to increase access to credit, with borrowers to make themselves more marketable, and with government institutions to create a regulatory and political environment that is favorable to credit availability. A credit guarantee might not have a lasting effect without this complementary capacity building. As a specific example, while a credit guarantee may induce a bank to extend loans to farmers, if these farmers have not acquired the accounting skills necessary to convince a bank of their profitability they will be unable to continue accessing credit after the guarantee expires.

Third, the specific partner in a credit guarantee has a large influence on the impact of the guarantee. Factors such as size, bank management, mission, strategy vis a vis the guarantee, and the extent to which the purpose of the guarantee is communicated to personnel, all play a role in the impact and sustainability of a guarantee. For example, it is up to the specific bank partner to decide how to strategically use the guarantee. Some banks inform loan officers about the guarantee, and some restrict knowledge to the board members. If loan officers know about the guarantee and use it to make loans to borrowers they view as risky, the performance of those loans may factor in future loan application appraisals, as compared to a loan officer who didn't know about the guarantee and therefore rejected an applicant outright. This could have an effect on the guarantee impact overall, if bank strategy affects the new borrowers under a guarantee.

Finally, the level of oversight and management of the guarantee by the USAID mission, by USAID, and by the bank itself, plays a role in the impact of the guarantee. Active management of the guarantee and communication with the partner financial institution can allow USAID and the mission to have a role in the implementation of the guarantee. Active management also allows problems such as low utilization to be recognized as early as possible so that mitigation can address and improve the guarantee.

Additionally, responsibility for financial monitoring of the guarantee is with USAID, while the mission is responsible for the development monitoring of the guarantee. The coordination between USAID and the mission is therefore an integral factor in the impact of the guarantee.

All of these factors, plus others, play a large role in the impact of a credit guarantee. Some of these factors can be encouraged or mitigated by USAID, while some may not. Each evaluation, while asking more specific questions related to the actual guarantee, should take all these factors into account when measuring the impact. The resulting impacts can be localized, or far-reaching, or both.

Levels of Results

There are three levels of results that come from a credit guarantee and from the factors listed above (technical assistance, legislative and regulatory environment, etc). These can be divided into three levels, the first of which is the most immediate level, the outputs of a DCA guarantee. The second level is partner institution behavior change, which are the outcomes. Finally, the broadest level is the market change, which is the impact and which can only be measured after the guarantee has expired and the market has had the opportunity to adjust to changes that the DCA and other factors have effected.

The most local and direct level of result is on the specific borrower under a DCA, and on the partner financial institution that made the loan. During the life of the guarantee, borrowers obtain credit guaranteed by USAID. The credit disbursed is the output that is directly attributable to USAID. In order to put a loan under guarantee, the financial institution must pay a fee that is a percentage of the outstanding loan. USAID expects that, in order to justify this premium, the partner institution views the borrower as risky and that without the guarantee it would not extend credit. Therefore, by paying the fee, the bank is paying for the ability to test a new loan product or borrower sector. The measurement at the output level is tracked by USAID's Office of Development Credit in utilization reports compiled twice a year.

In order to measure how the DCA changed bank behavior, one must look at the outcome level of impact. For example, this guaranteed loan could be to an existing client, it could be to a client that has used the bank for personal savings and is now using the bank for business loans, or it could be to a client that has different loan terms with the guarantee, or it could be to an entirely new client altogether. How a bank changes its behavior with the guarantee is seen in the outcome that is a result of the output. This describes the second level of impact, the behavior change that resulted from the guarantee. If the same borrower that had a guaranteed loan is able to subsequently secure a loan from the bank after repaying the guaranteed loan, he has proven himself a creditworthy borrower to the bank. This is expected because the borrower has established a credit history with the financial institution. If the bank extends loans to the same customer without a guarantee, it is evident that the bank's behavior has been affected by the guarantee and as such this is measured as an outcome. Another outcome is visible when banks lend without a guarantee to new customers in the same underserved sector, once they have made a decision that the targeted sector is not as risky a cohort as it had previously thought. In this case, the lender was a partner to USAID for the life of the guarantee, but the borrower was not ever a beneficiary of a USAID-guaranteed loan.

Finally, the furthermost level of impact is what USAID calls the “demonstration effect,” and refers to the longer term goals that occur well after a guarantee has expired. The credit guarantee alone is not responsible for change at this level, but the confluence of factors described in the section above can have a lasting effect on the landscape of financial markets and products in a given country or market. For example, this impact is evident when other financial institutions that were not a partner to USAID begin lending to the same targeted sector as USAID’s partner did, once the competitors have observed that the sector is profitable. This competition can lead to better terms for borrowers, such as lower interest rates and collateral requirements, and more credit made available. This is the furthest level of impact that relates to the USAID credit guarantee, and as such is the hardest to attribute to the guarantee itself.

In conclusion, it is important that each evaluation, while taking into account the differences in each guarantee, examine the outputs, outcomes, and impacts of each guarantee, and explore the factors and context of each as well. Throughout the course of the contract, it will be necessary to compare the evaluations to find common themes that can inform future evaluations. It is anticipated that some evaluations themselves will be “meta-evaluations,” studying the evaluations themselves to aggregately measure the factors for success and failures of USAID’s credit guarantees.