



Graduation with Resilience to Achieve Sustainable Development

GRAD is a five-year USAID-funded project designed to help the Government of Ethiopia find sustainable solutions to chronic food insecurity. The project supports households enrolled in the government's Productive Safety Net Program (PSNP) so that they may diversify livelihoods options, improve on- and off-farm productivity, access microfinance, and link with markets. GRAD also improves household and community resilience by: promoting women's empowerment; improving nutritional practices; and introducing local climate change adaptation mechanisms. CARE Ethiopia leads a consortium that includes REST, ORDA, CRS/MCS, Agri Service Ethiopia, and SNV. In addition, GRAD partners with 11 microfinance institutions (MFIs) and credit unions to improve access to financial services among chronically food insecure households. The project works in 16 districts in Amhara, Tigray, Oromia and SNNPR.

GRAD Learning Brief #4

Loan Guarantee Funds

The background/problem: Evidence from around the world shows that access to microfinance can vastly improve a poor household's ability to engage in productive economic activities and increase household income. However, due to the limited capacity of Ethiopian MFIs and rural savings and credit cooperatives (RuSACCOs) and the lack of incentives for them to work with food insecure rural households, the vast majority of chronically food insecure households are excluded from formal financial services. Recent studies have shown that only 7% of rural Ethiopian households have ever received an MFI loan and one can safely assume that most of the 7% are not safety net households. In addition to being risk averse, many MFIs in Ethiopia suffer from poor liquidity and lack mobility for on-site service provision. The need exists, therefore, to strengthen MFI capacity, while building in incentives to encourage them to work with poor rural households, as their mission statements suggest.

GRAD's financial inclusion strategy: Initially, GRAD builds the financial literacy and productive capacity of rural households in part by facilitating village savings and loan activities. GRAD then helps participants to develop business plans to be used for accessing loans. Households (or occasionally groups) are then linked with MFIs or RuSACCOs to apply for loans. In the short term, this linkage helps households get involved in productive livelihoods activities. Longer term, these experiences demonstrate to the MFIs that such households can be good investments; they will make productive use of credit and repay loans on time. It is expected that, based on this, MFIs should accept GRAD households as permanent clients. Unfortunately, the micro-finance sector in Ethiopia is still young; many MFIs lack adequate capital to take on a large set of new clients and need seed money to expand quickly. GRAD has provided each institution a Loan Guarantee Fund (LGF) to both mitigate perceived risks and build financial capital for large scale credit provision.

Within this strategy, GRAD works with eight private MFIs and three RuSACCO unions and has turned an LGF investment of USD3.52 million into loans for more than 50,000 HHs valued at USD12.64 million (including 2nd and/or 3rd round loans for some borrowers). Observing high loan repayment rates from these households, MFIs/RuSACCOs have started taking them on as regular clients. This is a clear indication that an LGF provided per the GRAD model can leverage greater amounts of private funds and motivate financial institutions to work with chronically food insecure households in the long-term. However, although the model appears to work, it works better in some institutions than in others as illustrated in the following cases.

The GRAD Loan Guarantee Fund (LGF) Model

A true LGF might hold money in escrow to compensate the financial institution in cases of loan default. However, such an approach would be extremely difficult to administer and would act as a repayment disincentive for both the MFI and the borrower. In GRAD's strategy, the LGF is transferred directly to the MFI and becomes a permanent part of their credit fund. In exchange for this support, partner MFIs commit an equal or greater contribution of private funds to the loan pool available to higher-risk PSNP households (since the LGF compensates them for the added costs and assumed risks of working with such clients).

Per the terms of agreements signed between GRAD and MFIs, each institution must contribute from one to five times the value of the LGF, depending on its internal financial capacity. Overall, for each LGF dollar paid by GRAD, about 2.5 dollars in MFI private funds have been leveraged. As the resulting loans mature and are repaid, the funds must remain in the MFI's credit account to be used specifically for future loans to food insecure households.

Case #1: Amhara Credit and Saving Institution (ACSI)

ACSI, GRAD's partner MFI for the Amhara Region, is a large regional MFI that is among the oldest in the country. In order to improve access to financial services for PSNP HHs in Amhara, GRAD and ACSI signed an MoU with clearly defined roles and responsibilities for each party. For its part, GRAD transferred an LGF of USD174,141 to ACSI, which in turn has contributed USD1,417,114 of private funds (more than eight times the value of the LGF). This has resulted in new loans to more than 5,400 households, enabling them to engage in GRAD-supported value chains. ACSI has had an interest in increasing the number of households in its client database but usually excluded the poorest households due to a lack of assets or collateral. The LGF motivated ACSI to finance the business plans of many GRAD households. The borrowers received appropriate training and technical support and most loans provided have been utilized in productive ways. GRAD households in Amhara are repaying at a rate of 94%, which exceeds local norms. The case of Maryihun Demissie serves as a good example. Using ACSI credit for initial investments, he was able to earn 35,260 birr (about USD1,760) from malt barley production and 4,000 birr (about USD200) from livestock fattening in one year. This income was more than adequate for loan repayment, household expenses, and further investment in the value chains. This and many similar cases is motivating ACSI to take on GRAD households as long-term clients.

This case makes it clear that when properly applied an LGF can be highly successful in leveraging private funds (for MFIs with ample resources) and encouraging the MFIs to lend to households they might otherwise avoid. The amount provided to ACSI was more than adequate to cover the added risk and cost of working with PSNP households. A key indicator going forward will be ACSI's ability and willingness to maintain GRAD households as long-term clients.

Case #2: Metemamen Micro-finance Institution

Metemamen also works in partnership with GRAD but, unlike ACSI, is a small private MFI. It is relatively young as an institution with fairly modest numbers for clientele, total assets, total value of its loan portfolio, etc. When GRAD began working in Arsi Negelle woreda in the Oromia Region, it signed an agreement with Metemamen to provide financial services to PSNP households there. GRAD's commitment was an LGF contribution and a plan to select and train households to make them ready for productive use of loans. Metemamen in turn was expected to contribute private funds at least equivalent to the amount of the LGF and, of course, to process loan disbursement and repayment for GRAD households in the area. However, while GRAD provided a LGF of USD332,245, Metemamen has only contributed USD149,718, far less than expected. As it turns out, Metemamen overpromised; it has limited private holdings and cannot yet mobilize enough financial resources either by generating public savings or accessing commercial loans. (This has also been the case with most other small, private MFIs and RuSACCOs.) In every other way, Metemamen has been an excellent partner and is providing quality services to an increasing number of clients. It just did not have the capital that an LGF would hope to leverage.

Unlike the ACSI case, where the LGF was able to leverage a much larger pool of credit for GRAD households, Metemamen did not contribute a commensurate share of private funds which, as it turns out, were not available. However, even in this case, the LGF added value as it helped Metemamen expand into new areas and begin supporting additional PSNP households. It also served to help Metemamen grow, by enlarging its loanable fund account.

GRAD Learning

Based on the practical experiences outlined above as well as feedback from numerous stakeholders, GRAD feels strongly that:

- Left alone, most MFIs/RuSACCOs do not loan to many PSNP households and do not consider them as credit-worthy. An LGF provided per the GRAD model leverages MFI private funds and encourages loans to seemingly higher risk clients.
- Given intensive business and technical training and support, poor and chronically food insecure households become credit worthy and represent a profitable new market segment for rural financial services providers. Under most circumstances, they will be productive, earn income, and repay their loans on time.
- Rural financial services providers will contribute private capital and assume greater risk if they are incentivized through a risk-sharing arrangement like the LGF (rather than receiving grants).
- It is not only the risk appetite and confidence of the financial institution that determines whether it can meet the demand for financial services from poor households but also its available capital. The financial sector in Ethiopia remains under-capitalized and incapable of meeting demand for rural credit.
- **IMPORTANT:** Beneficiaries should never be informed that their loans are guaranteed or that loan funds originated from donors. There is strong evidence that repayment rates decline sharply when field staff and officers from financial institutions share this information with the public.