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CASE STUDY: FONDO DE GARANTÍA PARA LA PEQUEÑA INDUSTRIA (FOGAPI) GUARANTEE FACILITY IN PERU microREPORT #79

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ACRONYMS AND ABBREVIATIONS

COFIDE	Corporación Financiera de Desarrollo S.A
CMAC	Cajas Municipales de Ahorro y Crédito
CRAC	Cajas Rurales de Ahorro y Crédito
DCA	Development Credit Authority
EDPYME	Entidades de Desarrollo para la Pequeña y Microempresa
FOGAPI	Fondo de Garantía para la Pequeña Industria
FONCODES	Fondo Nacional de Compensación y Desarrollo Social
IDB	Interamerican Development Bank
GoP	Government of Peru
GTZ	Deutsche Gesellschaft für Technische Zusammenarbeit
LG	Loan Guarantee
LPG	Loan Portfolio Guarantee
MCD	Maximum Cumulative Distribution
MFI	Microfinance Institution
MSEs	Micro and small enterprises
MSMEs	Micro, small, and medium-sized enterprises
ODC	USAID Office of Development Credit
OMD	USAID Office of Microenterprise Development
PG	Portable Guarantee
NGO	Nongovernmental Organization
ODC	Office of Development Credit (USAID)
SMEs	Small and medium-sized enterprises
SO	Strategic Objective
USAID	United States Agency for International Development

FOREWORD

The purpose of this review, funded by USAID’s Office of Development Credit (ODC) under the DAI, DCA Support Task Order, was to (i) assess the utility of USAID’s Development Credit Authority (DCA) credit guarantee mechanism as a programming tool to help microfinance institutions (MFIs) formally integrate into financial systems, and (ii) document observations that will assist USAID missions improve future wholesale MFI DCA guarantees. This review was conducted in cooperation with USAID’s Office of Microenterprise Development (OMD).

This DCA case study, along with one other on the Deutsche Bank Global Commercial Microfinance Consortium, produced by ODC, is part of a larger DCA research effort being conducted through the Financial Services Knowledge Generation Project (FSKG), which has previously produced three DCA case study reports, bringing the total number of DCA case study reports to five. The objective of these studies is to inform and assist Missions when designing and managing DCA guarantees for MFIs seeking access to commercial funding sources and capital markets.

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EXECUTIVE SUMMARY

Peru's microfinance industry has been one of the most dynamic in the region, showing particularly impressive gains in the past six years. Regulatory changes in the microfinance sector, the downscaling of commercial banks, and macroeconomic stability have led to widespread growth in the industry. Since December 2000, microfinance loans have increased fivefold, reaching over US\$2.0 billion in the first nine months of 2006. With limited government financing, the expansion has been financed largely through private capital, primarily consisting of deposits. Those institutions that cannot take deposits, NGOs and regulated EDPYMEs (Entidades de Desarrollo para la Pequeña y Microempresa), however, have faced significant capital constraints. It is in this context that USAID Peru, with the assistance of USAID's Office of Development Credit, structured an innovative DCA re-guarantee in 2002, which primarily benefited regulated EDPYMEs through a two-tiered guarantee structure. The structure was a re-guarantee, in which USAID provided a partial guarantee to FOGAPI (Fondo de Garantía para la Pequeña Industria), a private guarantee facility, which in turn provided a partial loan guarantee to financial institutions lending to the MSME sectors. The FOGAPI guarantee program provided an interesting opportunity for USAID to leverage the impact of its guarantee funds aimed at the sector. With a US\$1.0 million ceiling on the guaranteed amount, the DCA re-guarantee supported over US\$3.9 million in loans to MFIs.

The implementation of the DCA structure varied from its original scope, which was perhaps too far-reaching. The structure had initially envisioned local commercial banks lending to microfinance institutions with the incentive of a FOGAPI guarantee. Commercial banks in Peru, however, were extremely conservative. Those that had an interest in microfinance were focused on downscaling into the MSE market themselves, which discouraged them from lending to possible competition. Instead, Oikocredit, an ethical investment fund based in the Netherlands, was the primary lender in this DCA re-guarantee structure.

The structure explicitly called for guarantees to target lending to NGOs, which were lending to the poorest segments of the MSE market. At the time, many of the stronger NGOs in Peru had converted to EDPYMEs, which are regulated non-deposit taking MFIs. Other NGOs either had access to soft loans or were insufficiently mature to access commercial capital. From the lender's perspective, NGOs that had not yet transformed were somewhat weaker, less attractive borrowers. In practice, FOGAPI focused its guarantees on growing the EDPYMEs. The FOGAPI/DCA structure facilitated loans to four EDPYMEs and one NGO.

FOGAPI's concentration of the re-guarantee in EDPYMEs greatly benefited these institutions, which had increasing credit needs as they were consolidating their market position following their transformation into regulated entities. Their legal inability to take deposits, and their strong demand for finance, made them prime candidates for the guarantee. The structure allowed EDPYMEs to access capital, without tying up liquidity from large cash deposits (in the form of CDs) that banks required as collateral. More important, however, the structure helped EDPYMEs build credibility with commercial lenders, particularly specialized foreign investment funds. In one case, Oikocredit became an equity investor of an EDPYME that is transforming into a deposit-taking financial institution. Some of the EDPYMEs used Oikocredit loan proceeds to back local currency loans,

which provided them significant support in matching their currency exposure as many EDPYMEs lend mostly in local currency.

The experience of a DCA re-guarantee structure through FOGAPI in Peru sheds light onto the benefits and costs of implementing re-guarantees. When USAID missions are working in an environment where local government agencies provide guarantee funds, a re-guarantee can be an effective tool to leverage available guarantees without duplicating efforts. In the case of FOGAPI, which was partly capitalized by the GoP as well as external donor funds, FOGAPI pledged these capitalized funds as guarantees and was able to pledge a greater amount of their capital because their guarantees were partially re-guaranteed by USAID. While there are few guarantee programs to compare to the Peruvian experience, the lessons from this re-guarantee can be applied in other contexts. In countries where apex institutions or government funds compete directly with the commercial sector in providing credit to the microfinance sector, USAID can consider structuring re-guarantees to encourage a shift away from direct lending by governments. The experience of FOGAPI shows that the potential impact of guarantee programs working through re-guarantee structures such as this can play a role in helping agencies transition from direct lending to the MSE sector, so that these agencies replace direct loans for guarantees and second-tier loans that facilitate local commercial lending to the sector. Finally, the experience of a re-guarantee has implications for USAID collaboration with commercial banks offering letters of credit and other guarantees to local borrowers.

BACKGROUND

Since the early 1990s, Peru's microfinance industry has been one of the most dynamic in the region. An early pioneer in the field of microfinance, Peru has received significant domestic and international attention in this sector. Government agencies, in collaboration with international donor organizations, have shown a commitment to developing a legal and regulatory environment that has nurtured the development of Peru's financial system, which has been increasingly inclusive of poorer segments of Peru's population. Interest rate liberalization and legislation to allow microfinance institutions (MFIs) to become regulated entities played a large role in this process. Bank downscaling into the MSE sector has also gained momentum, contributing to greater inclusion of low income groups in the financial system. Since December 2000, microfinance loans have increased fivefold, reaching over US\$2.0 billion in September 2006. With limited government financing for MFIs, access to private capital has played an essential role in this growth. Many of those Peruvian microfinance institutions which are legally permitted to take deposits have raised capital through this source of funds. However, other institutions that have recently transformed from NGOs to regulated non-deposit taking MFIs, called EDPYMEs, have faced significant capital constraints.

It is in this context that USAID/Peru, with the assistance of the USAID Office of Development Credit (ODC) began to explore mechanisms to increase access to finance for MFIs that did not have access to deposits, which in many cases reach the poorer segments of Peru's microfinance market. This case study reviews an innovative DCA re-guarantee structure that was developed in 2002, which primarily benefited these regulated, non-deposit taking MFIs through a two-tiered guarantee structure. The structure provided a partial re-guarantee for partial loan guarantees from FOGAPI (Fondo de Garantía para la Pequeña Industria), a private guarantee facility established as a foundation with Board participation from the Government of Peru (GoP).

THE MICROFINANCE MARKET IN PERU

MARKET TRENDS

Despite being one of the most developed microfinance markets in the region, Peru's microfinance industry is highly fragmented, with characteristics that are more common in smaller and less developed microfinance markets such as high operating costs and high interest rates. Microfinance institutions in the country are often concentrated geographically or are limited in terms of scale and availability of services.

Approximately 62 institutions provide MSE services country-wide to some 900,000 microenterprises¹. According to the Ministry of Labor and SUNAT², there were approximately 2.5 million microenterprises in Peru in 2004. Unofficial estimates place this figure at up to 2.8 million today. Despite the large number of financial institutions, market access is still low, particularly in rural areas. Approximately 36% of MSEs currently have access to financial services from a variety of sources including commercial bank, non-bank financial institutions and NGOs.

In an effort to increase supervision of microfinance activities without overburdening the reporting and provisioning requirements of smaller institutions, the GoP has encouraged six different types of financial intermediaries in the MSME sector summarized in Table 1. Ironically, this broad range of institutions has limited competition and efficiencies to some extent, as geographic limitations have protected institutions from competing head to head.

TABLE 1: OVERVIEW OF REGULATORY ENVIRONMENT FOR MICROFINANCE INSTITUTIONS IN PERU

	Supervised	Loans	Deposits	Cross Regional
Banks	√	√	√	√
<i>Instituciones Financieras</i>	√	√	√	√
CMACs	√	√	√	
CRACs	√	√	√	
EDPYMEs	√	√		√
NGOs		√		√

Cajas Municipales de Ahorro y Crédito (CMACs) In an effort to decentralize Peru's banking system and increase the supply of financial services for lower-income individuals, the first CMAC was created by the Peruvian government with technical assistance from Germany's technical cooperation agency GTZ in 1982. Lauded for their governance structure, autonomy and

¹ Perfil de las Microfinanzas en Latinoamérica en 10 Años: Visión y Características. Beatriz Marulanda & María Otero, Acción Internacional. Requested by the Microcredit Summit, First Presentation for Regional Meetings of Latin America and the Caribbean. April 2005.

² Peruvian tax authority

transparency (despite being owned by municipalities), and their impressive ability to mobilize savings, the Cajas Municipales are currently the single most important providers of microfinance in the country. Although they only represent 6.58% of the entire retail banking market, they represent 33.46% of the microfinance sector's portfolio³. In many departments in the interior of Peru, the CMACs have surpassed the commercial banks to become the main financial services providers. Currently, there are fourteen CMACs and one CMCP (Caja Municipal de Crédito Popular) operating in nine provinces in the interior and metropolitan Lima. CMACs operate in limited geographical areas, and were only permitted to operate in metropolitan Lima in 2003.

Cajas Rurales de Ahorro y Crédito (CRACs): CRACs were also created by the Peruvian government, with the goal of providing financial services to rural microenterprises. In contrast to the CMACs, their performance has not been as strong.

Entidades de Desarrollo para la Pequeña y Microempresa (EDPYMEs): EDPYMEs were established as a direct result of the regulatory reforms in 1994. Most EDPYMEs grew out of existing NGOs which chose to convert into regulated financial institutions. Under the Superintendency of Banks and Securities (SBS) regulatory framework, EDPYMEs have lower capital requirements, can manage credits, but are not allowed to mobilize deposits. Because of the lower capital requirements, EDPYMEs themselves take on varying shapes and sizes, hence performance has varied widely. The size of the portfolios range from US\$ 1.2 to 65.2 million, the PARs from 3.87 to 19.85%, and ROE from minus 2.99 to plus 42.68%. While EDPYMEs are permitted to operate nationwide, their limited access to capital gives them a more regional focus.

“Instituciones Financieras”: This is a category of financial institution that was created by the 1994 law that also created the EDPYME structure. An *Institución Financiera* would have much the same lending authority as an EDPYME, but would also be able to mobilize non-current account deposits, hence would have lower reserve requirements than banks. This type of financial institution was envisaged as a next step for the EDPYME transition to offering full service. At present only three entities have this charter, two small operations and a third established by a commercial bank as a microfinance subsidiary which has stopped lending.

Non-governmental organization MFIs (NGOs): NGOs are unregulated financial services providers, and have become an increasingly marginal source of retail financial services in Peru as some of the stronger institutions have become regulated, usually transforming to EDPYMEs. According to the most recent data from December 2005, these NGOs had a combined portfolio of US\$27 million, the equivalent of only 2% of the formal sector's microcredit portfolio⁴. Nevertheless, they continue to provide services to the poorest clients in the MSE sector. NGOs can lend nationally, but are constrained from expanding country-wide as they cannot access deposits.

Banks: Historically commercial banks in Peru have focused on serving medium and large enterprises and salaried individuals. More recently, there have been efforts from some of these institutions to go “down market” to serve a smaller or riskier clientele, mostly in the greater Lima area. Commercial bank penetration of the microfinance sector has been significant over the past decade, reflecting both the transformation of an NGO into a bank (MiBanco) as well as the downscaling of commercial

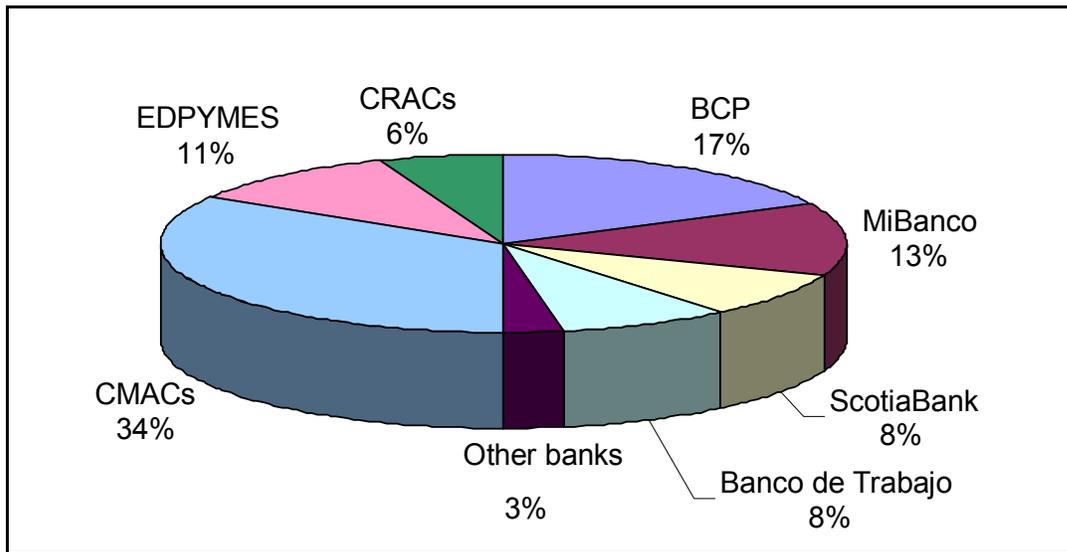
³ Superintendencia de Banca y Seguro. 9/30/2006 data. <http://www.sbs.gob.pe/PortalSBS/Estadistica/index.htm>

⁴ Estimated from COPEME data December 2006.

banks into the MSE sector (Banco del Trabajo, Banco de Crédito, ScotiaBank), attracted to the market because of the high interest rates charged on micro loans. As banks participate more in the market, they will likely drive down the interest rates, and over time, may drive themselves out of the MSE market. Banks can both take deposits and operate nationally, thus are dominating the retail SME market and providing the greatest competition in the microfinance market.

Note: Peru also has cooperatives, but these focus mainly on consumer credit, leaving the microfinance niche to the other financial institutions. They play a minor role in the retail microfinance.

FIGURE 1: FINANCIAL INSTITUTION PARTICIPATION IN THE MSE SECTOR



Data from Superintendencia de Banca y Seguro. <http://www.sbs.gob.pe/PortalSBs/Estadistica/index.htm>. Note: this presentation does not include NGO loan portfolios, estimated at 2% of the market, because the NGOs do not report data to the Superintendencia.

THE GOVERNMENT OF PERU’S ROLE IN THE MICROFINANCE MARKET

LEGAL AND REGULATORY SUPPORT

Since the early 1990s, the Government of Peru has directed significant efforts toward creating a positive enabling environment for the private provision of microfinance services. With the exception of debt forgiveness and interventions in the rural and agricultural finance sector during the Fujimori and Toledo administrations, the GoP focused on regulatory reforms and transparency initiatives that support the efficient provision of financial services. These initiatives included:

- Creating a legal framework in 1994 which allowed for several different kinds of financial institutions, such as the EDPYMES and *Instituciones Financieras*. These reforms decreased the requirements for registered and regulated institutions, bringing down costs and barriers to entry, and encouraging new providers to upscale, thereby creating a more competitive environment.

- Allowing private sector credit bureaus to be established which has resulted in a competitive market for credit information.
- Streamlining property registration and creating registries for guarantees, property, and individuals. By doing so, the GOP has helped to eliminate information asymmetries between the borrowers and lenders. MFIs can easily confirm lenders' identities, property holdings, and the outstanding guarantees associated with said property.

The regulatory environment has encouraged MFIs to begin the process of transforming into regulated institutions. Many well managed and profitable NGOs transformed into EDPYMEs in 1997 and 1998 and some are currently in the process of applying for status as regulated *instituciones financieras*. The main example of a transformation in the Peruvian market is MiBanco, which transformed from an NGO into a bank, thus has been able to mobilize deposits as well as obtain commercial funding from abroad, from loan funds that are more comfortable lending to a supervised institution than an NGO. It is important to note that MiBanco has been targeting its growth precisely among low income clients, where its expertise in microfinance lending methodologies provides a competitive advantage vis-à-vis local banks that are downscaling into the MSE market. Over time, further de-regulation in the financial sector and increased competition should lead mergers, acquisitions and geographic expansion of larger banks such as MiBanco. This will have a positive, albeit gradual impact on reducing interest rates as well as improving efficiency in the microfinance market.

The Government of Peru's funding support to the MSE sector has come directly and indirectly through two entities, COFIDE and FOGAPI.

SECOND TIER LENDING: COFIDE

In 1992 the GoP discontinued its direct lending to the MSE sector, and instead has provided second tier financing through La Corporación Financiera de Desarrollo S.A.(COFIDE). COFIDE is a government agency, which loaned US\$68.6 million to CMACs, CRACs and EDPYMEs⁵ in 2004, up from US\$63.8 million in 2002. While this represents less than 7% of the deposits mobilized by these same institutions, loans from COFIDE have been an inexpensive way for MFIs to raise capital locally. At the same time COFIDE's loans to all regulated institutions lending to the MSE sector were US\$167 million in 2002 and increased to US\$237 million in 2004, showing COFIDE's interest in backing the larger regulated institutions.

It is important to note the relationship between COFIDE and FOGAPI. FOGAPI's Board includes various members of the GoP including a COFIDE representative, despite FOGAPI's status as a separate private foundation. FOGAPI also provides loan guarantees for many of COFIDE's loans to the MSE sector, which strengthens COFIDE's financial situation by reducing its risk significantly. FOGAPI is not on the government's fiscal budget, despite the government's role in setting its strategic objectives. This relationship has allowed the GoP to leverage its own resources significantly, while minimizing some of its risk.

⁵ COFIDE Website. www.cofide.org.pe

FOGAPI BACKGROUND

FOGAPI (Fondo de Garantía para la Pequeña Industria) is a private guarantee facility established as a foundation in 1979 with the support of GTZ, COFIDE, the Association of Small and Medium Industrial Enterprises of Peru (APEMIPE), the National Society of Industries (through COPEI), the National Service of Training in Industrial Work (SENATI), and the former Industrial Bank of Peru. FOGAPI was created to provide loan guarantees to support the MSE sector in gaining access to finance.

Historically, FOGAPI has provided two core products: letters of guarantee for SMEs and financial institutions, and portfolio guarantees for financial institutions. FOGAPI's guarantees are based on the principle of risk sharing, and are generally partial guarantees representing 50% of a total loan. Initially, FOGAPI's mandate focused heavily on guaranteeing loans to SMEs directly, but more recently attention has been shifted to guaranteeing second-tier loans to financial institutions that are lending to MSMEs.

USAID SUPPORT OF MICROFINANCE—USAID/PERU DCA GUARANTEES

In 2002, USAID adopted its Microfinance Initiative Project to support microfinance NGOs. This included assistance through COPEME, an MFI network organization that provides technical assistance, and consolidates and publishes financial information for the sector, supporting the transparency and uniformity of data.

With the support of the Office of Development Credit in Washington, USAID/Peru began to grapple with the lack of access to credit facing the country's microfinance institutions. USAID responded with a variety of DCA structures. In the case of MiBanco, a growing microfinance bank that had recently transformed from an NGO, USAID developed a bond guarantee structure that gave MiBanco an alternative to commercial bank financing. MiBanco was able to access finance in the local capital markets through this mechanism. Subsequently the Andean Development Corporation (CAF) guaranteed its second bond issue. More recently the bank's track record alone has allowed it to issue debt in the local market without guarantees. However, for smaller NGOs and recently transformed EDPYMEs, financing through the local bond markets was not a feasible alternative. USAID/Peru therefore designed a guarantee structure aimed at these smaller providers of microfinance services. The structure leveraged the availability of local guarantees through FOGAPI, aimed at supporting the MSE sectors.

THE FOGAPI RE-GUARANTEE MECHANISM

The DCA re-guarantee was designed with the intention of facilitating local commercial bank loans to microfinance NGOs. The facility had a guarantee limit of US\$1 million, covering up to US\$2 million of FOGAPI's guarantees. This structure aimed to exploit the leverage that a partial guarantee of FOGAPI's own guarantees would have in the local financing market. The guarantee for US\$1 million covered 50% of FOGAPI's guarantee, which in turn covered 50% of lender's credit to the MFI. With the re-guarantee, MFIs would be able borrow four times the amount of capital guaranteed by FOGAPI. In all, \$3.9 million of credit was facilitated by the FOGAPI and DCA guarantees of \$1 million (or 25%) each.

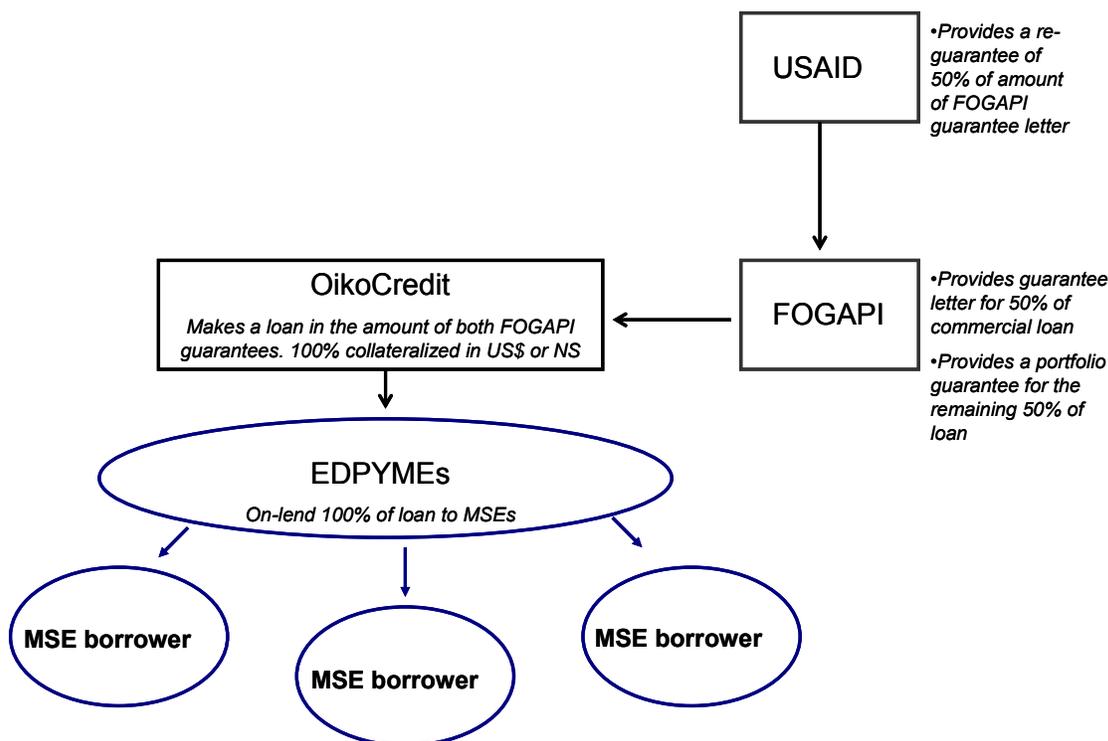
The program had a slow start, with most loans having 1-2 year terms issued in 2003 and 2004. The DCA re-guarantee was approved in 2002 and originally expired after 3 years. It was later extended until 2006 but loans coming due were too large to leave enough room in the guarantee to roll over more funds.

TABLE 2: LEVERAGE EFFECT OF DCA RE-GUARANTEED TRANSACTIONS

Borrower	USAID Guarantee (US\$ equiv)	FOGAPI guarantee letter (US\$ equiv)	Total borrowed funds ¹⁶ (US\$ equiv)	Lender
EDPYME Confianza	\$251,345	\$251,345	\$1,005,380	Oikocredit/Creditosud
EDPYME CREAR Arequipa	\$150,000	\$150,000	\$600,000	Oikocredit
EDPYME EDYFICAR	\$250,000	\$250,000	\$1,000,000	Oikocredit
AMA	\$25,000	\$25,000	\$100,000	Oikocredit
EDPYME Proempresa	\$312,500	\$312,500	\$1,250,000	Oikocredit
TOTAL	\$988,845	\$988,845	\$3,955,380	

While USAID had originally envisioned the guarantees for commercial bank lending to MFIs, in fact Oikocredit, an ethical investment fund based in the Netherlands, was the sole lender. Because Oikocredit required 100% guarantees, FOGAPI also provided MFI borrowers with an additional loan portfolio guarantee. This second guarantee involved FOGAPI issuing a separate guarantee for the MFI’s loan portfolio, in an amount covering the remaining uncollateralized 50% of the Oikocredit loan value. This second guarantee was unrelated to the DCA facility, and MFIs were charged an additional fee for the loan portfolio guarantee. The structure of funds flow and guarantees are shown on the diagram below.

FIGURE 2: USAID DCA REGUARANTEE STRUCTURE WITH FOGAPI



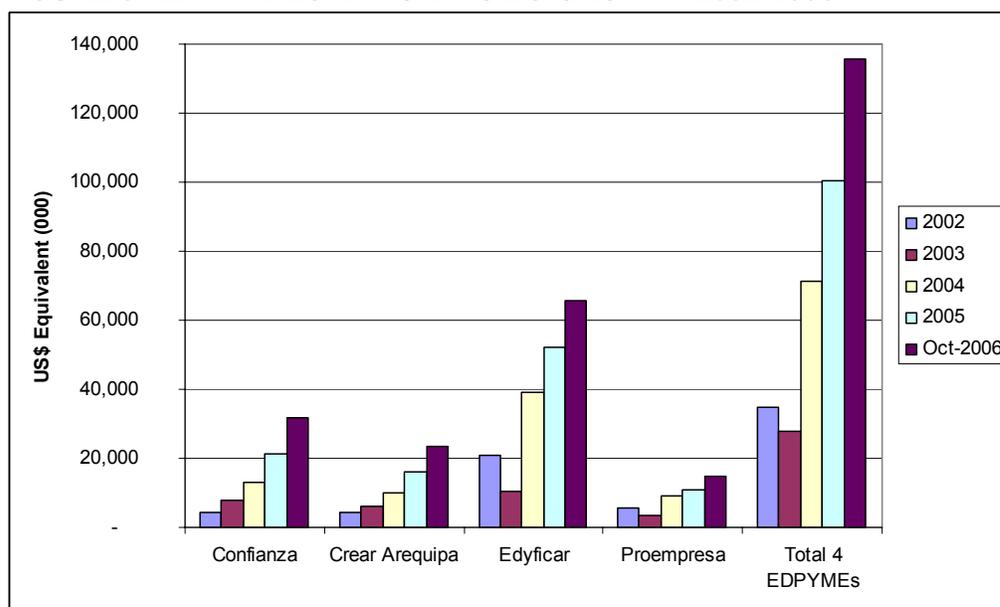
⁶ Represents the total amount borrowed over the life of the DCA re-guarantee (multiple loans). Does not include amounts guaranteed by FOGAPI’s portfolio guarantees.

DCA OVERALL IMPACT ON MFI BORROWERS

While the structure had initially aimed to facilitate loans to NGOs, EDPYMEs that had transformed from NGOs into non-deposit taking regulated entities in the late 1990s were the main beneficiaries. Four of five borrowers under the structure were EDPYMEs and one was an NGO, which received only 2% of the loans backed by the structure. Various factors influenced the concentration of the re-guarantee among EDPYMEs. Many of the NGOs that were strong candidates for loans had already self-selected and transformed into EDPYMEs. Further, NGOs with strong financial performance and management were still seeking soft loans and grants to sustain their operations and finance both credit and non-credit activities.

EDPYMEs were expanding their portfolios rapidly, hence had large capital needs. Figure 3 below reflects that loan portfolios for the four EDPYMEs that received FOGAPI guarantees with DCA re-guarantees began to grow significantly in 2004. EDPYME EDYFICAR showed the most impressive results, as its loan portfolio increased nearly fourfold in 2004 to over US\$39 million. The EDPYMEs who borrowed using the DCA re-guarantees earlier, such as Confianza and Edyficar, grew the fastest.

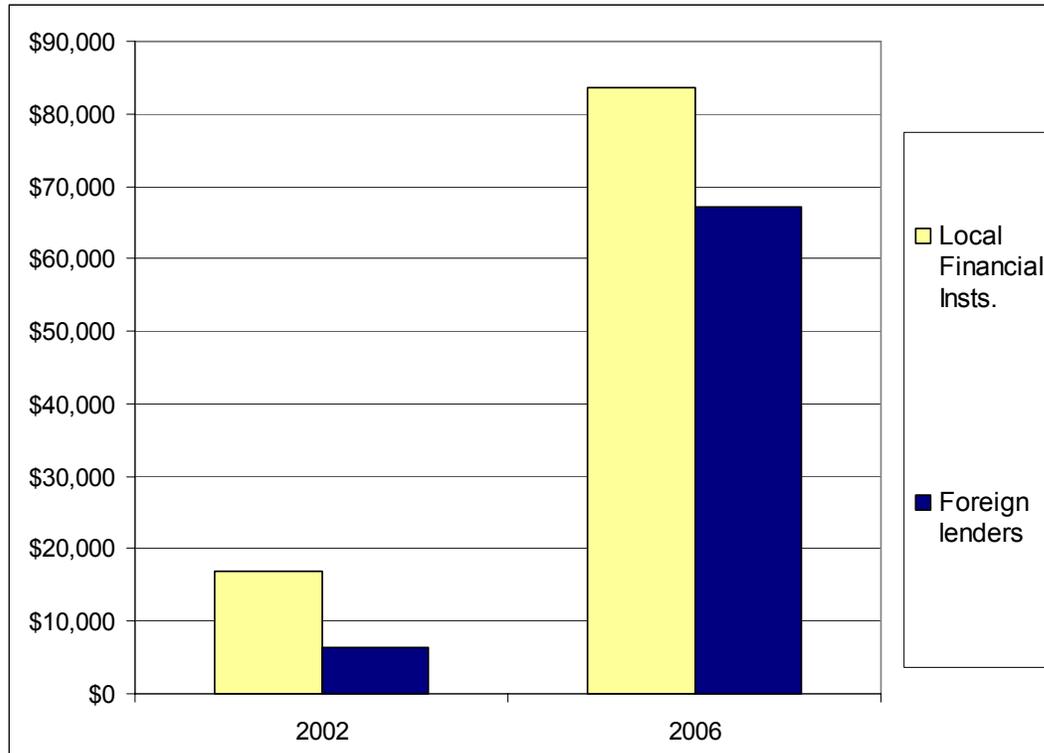
FIGURE 3: EDPYME LOAN PORTFOLIO GROWTH 2002-2006



In addition to providing finance, which was relatively small compared to the EDPYMEs' overall needs, the structure helped EDPYMEs build a track record in the external commercial markets. The four EDPYMEs interviewed for this case study all claimed that the Oikocredit loan was an important first step in raising capital from international investment funds. In some cases, this loan was a first foray into commercial borrowing, and played an important role in helping EDPYMEs build credibility with a broad range of domestic and international borrowers and access new funds in a relatively short time. This allowed them to source a variety of funds going forward to help sustain their impressive growth. There has been a significant expansion in these funding sources, which have replaced donations and soft loans on their balance sheets. Foreign loans to the four EDPYMEs increased from US\$6.5 million in 2002 to US\$67 million in October 2006, as shown in Figure 4 Local sources of funds, still primarily from the GoP's COFIDE, have also increased substantially.

This increased availability of capital has led to greater competition among lenders for quality borrowers, and thus helped lengthen loan terms and facilitate greater funding in local currency.

FIGURE 4: GROWTH IN FOREIGN AND DOMESTIC BORROWING: FOUR EDPYMES 2002 VS. 2006



DCA IMPACT ON EACH MFI BORROWER

EDPYME CONFIANZA

EDPYME Confianza is a dynamic MFI, with origins as a rural NGO that has financed its loan portfolio growth with creative and proactive mechanisms. It started as an NGO called SEPAR, which began making small loans to rural women in Peru’s Huancayo Province in 1993. With funding from IDB, the European Union and the Peru-Canada Contervalue Fund, it was able to build up a rural microfinance portfolio some 3-4 years later and transform into a regulated financial institution in 1997 as EDPYME Confianza. Initially, about 85% of EDPYME Confianza’s loans were to the rural sector. However, the MFI’s portfolio growth of approximately 60% per year has surpassed the growth in rural demand, and EDPYME Confianza’s rural portfolio has declined to 70% of its total portfolio. Confianza has 35,000 clients in 6 regions of the country and 12 provinces. It lends in local currency and has an outstanding portfolio of approximately US\$33 million. Confianza’s loans are small, averaging \$880 and ranging between US\$100 and US\$3,000, reflecting its still predominantly rural clientele.

In 2002, EDPYME Confianza approached a variety of creditors. At the time, funding sources were limited and costly, as both local and foreign sources of commercial capital were requiring at least

100% of the loan on deposit as collateral. In early 2003, EDPYME Confianza approached Oikocredit for a loan, which was also required a guarantee but offered more flexible terms with regard to the structure of this guarantee. The USAID re-guarantee through FOGAPI was able to provide almost one half of the requirement for an Oikocredit loan. An additional 130% of the remainder was covered through a loan portfolio guarantee by FOGAPI. Since this first transaction, Confianza has continued to work with FOGAPI guarantees and Oikocredit as well as other lenders to source its funding. It has also been able to diversify its funding sources significantly, having shown that it is a strong borrower in the commercial markets. Currently, Confianza is raising capital from a range of external lenders including Triodos, Novib, Alterfin, Microvest and SIDI. Additionally, it has begun to access external local currency loans for the first time through the International Finance Corporation (IFC). It has been one of the few EDPYMEs that has successfully negotiated local bank loans using structures including standby letters of credit from foreign sources and foreign investor-owned funds on deposit at local banks as collateral for loans. In many cases, Confianza is able to leverage deposits, borrowing about 20%-30% more than what is pledged as collateral. Confianza is also negotiating some subordinated debt arrangements that would allow investors the option to become equity shareholders going forward.

EDPYME EDYFICAR

EDPYME EDYFICAR, the largest of the EDPYMEs, is a growing financial institution with 13 years experience in lending to the microenterprise sector. The MFI began as CARE Peru and received assistance from USAID, the government of the Netherlands, the IDB and others. It was transformed into a supervised EDPYME in 1999. EDYFICAR has an average loan size of US\$900, serving over 65,000 borrowers in Peru.

In 2004, most of EDYFICAR's funding sources were composed of soft loans and donations. It also received local currency funding from COFIDE as well as another government development institution, FONCODES (Fondo de Cooperación para el Desarrollo Social). In total, EDYFICAR borrowed only US\$1-2 million from external markets. The DCA re-guarantee played an important role in building confidence in EDYFICAR and helping it access commercial funds from abroad. EDYFICAR received a US\$500,000 loan from Oikocredit, which was backed by a US\$250,000 FOGAPI letter of credit with a US\$125,000 loan re-guarantee from USAID. FOGAPI also provided a 130% loan portfolio guarantee for the remainder of the loan in order to help EDYFICAR meet Oikocredit's collateral criteria. Since receiving the loan from Oikocredit, EDYFICAR has borrowed over US\$20 million from the external markets at commercial rates. It has also impressively diversified its funding. Some 34% of its financing comes from local currency loans from COFIDE and FONCODES, and another 18% from local banks, collateralized by US dollar deposits. The remaining funding, in US dollars, comes from various international lenders and investment funds including Oikocredit, the IFC, Blue Orchard and Microvest. EDYFICAR noted that while the FOGAPI guarantee played an important role in transitioning the MFI to commercial financing, it did not influence the interest rates available to EDYFICAR.

EDPYME PROEMPRESA

PROEMPRESA's origins were as an NGO, the IDESI Network, which provided credit to MSEs in 19 departments of Peru for over 12 years. It transformed into an EDPYME in 1997. PROEMPRESA's

main clients are urban and semi-urban microentrepreneurs. PROEMPRESA has approximately 18,000 clients and an average loan size of US\$850.

PROEMPRESA's loan portfolio is the smallest that has benefited from the DCA guarantee, with the least growth in loans (160% vs. an average increase of 380% for the group). This slower growth has also mirrored PROEMPRESA's relatively limited access to foreign funding sources. In 2004, PROEMPRESA approached FOGAPI for a guarantee, upon the recommendation of Oikocredit. It received a total US\$1.25 million from two loans from Oikocredit, with a combined USAID re-guarantee of US\$325,000. PROEMPRESA's funding is still predominantly domestic, as its funding needs have been lower than those of larger EDPYMEs. Additionally, PROEMPRESA is particularly interested in receiving local currency loans, which are still difficult to access from foreign funding sources. Domestic sources of funds have included CMACs, commercial banks (with 100% collateral on deposit)⁷, COFIDE, Agrobanco, Banco Nación, and FOGAPI itself. It has also received some additional foreign loans, including loans from international socially responsible investment funds. Most loans have had guarantees, but more recently, some of the loans the institution is negotiating do not require guarantees. PROEMPRESA is currently in the process of transforming into a deposit-taking *institución financiera*. Interestingly, the initial loan with Oikocredit has led to a strong relationship between the EDPYME and Oikocredit, which will be taking on a shareholder role in the new institution. In this case, the guarantee has influenced access to equity investments more than debt financing.

EDPYME CREAR AREQUIPA

CREAR Arequipa is an EDPYME based in Peru's southern region of Arequipa, and with operations in Lima. CREAR Arequipa transformed from its NGO status in 1997 into an EDPYME. Its target market is poor, semi-urban microentrepreneurs, whose loans comprise 95% of CREAR Arequipa's loan portfolio. Its average loan size has been approximately US\$980 over the course of the past five years. It has increased its client base gradually from 2,151 in 2000 to 27,000 to date. Along with this impressive growth, it has been one of the most profitable EDPYMEs in Peru, with an average net margin of 38%.

In 2002, when CREAR Arequipa approached various domestic and international institutions in search of local currency funding in order to better match its liabilities to its assets, which were mostly denominated in Peruvian Nuevos Soles. While local lenders (COFIDE, FONDEMI, and FONCODIF) were lending in local currency, much of CREAR Arequipa's borrowing came from international sources including the Andean Development Corporation (CAF) and Oikocredit. However, these loans were in US dollars. Even Oikocredit, which had loaned to the MFI in the past, was not comfortable taking local currency risk. Oikocredit recommended that CREAR Arequipa seek a FOGAPI guarantee, through which it would be able to lend CREAR Arequipa US\$1 million equivalent in local currency. The DCA guarantee only covered 50% of FOGAPI's 50% guarantee, however, Oikocredit required a fully-guaranteed loan. As a result, FOGAPI also offered CREAR Arequipa an additional portfolio guarantee covering its portfolio for the remaining value of the loan.

CREAR Arequipa has initiated the process of transforming into a regulated deposit taking *institución financiera* with the support of various donor agencies. The transformation specifically aims to help

⁷ PROEMPRESA has borrowed from commercial banks that are not involved in direct lending to the MSE sector.

consolidate the MFI's position with its target market by allowing it to offer additional products and services including deposits. CREAR Arequipa will be able to further diversify its sources of funds as well as create additional sources of local currency financing. Since receiving its first Nuevo Sol loan with a DCA re-guarantee, the MFI has been able to ask international lenders to provide more competitive terms, particularly with regard to local currency lending, than prior to the re-guarantee. According to the institution, this has been one of the primary advantages of the FOGAPI guarantee that was re-guaranteed with USAID's DCA structure.

ASOCIACIÓN MUJERES EN ACCIÓN

Asociación de Mujeres en Acción (AMA) is the only unregulated MFI that has received a FOGAPI guarantee. AMA is an NGO, founded in 1998 to provide social programs to the women of the La Libertad region of Peru. AMA began providing loans to clients to complement its social programs. Although the NGO's portfolio is still small, its microfinance activities have grown significantly over the past five years. Initially, AMA concentrated on women borrowers from the semi-urban area around the city of Trujillo. More recently, AMA has expanded its services to more rural clients, including both male and female farmers. Currently about 70% of AMA's clients are women. AMA's familiarity with its target population, indigent women, has cushioned the institution from much of the competition in the market in La Libertad from the region's CMACs, which lend to a slightly higher income group. AMA's average loan size is \$400 and some 80% of its clients are classified as subsistence level. AMA serves these clients with a variety of products, including working capital loans, loans for fixed assets, remittances, foreign exchange, wire transfers and funeral insurance.

In 2002, as AMA was trying to expand its lending operations, it had limited access to finance. AMA has received technical assistance from COPEME, which referred the NGO to FOGAPI. It was financing its portfolio through funds from the Ecumenical Church Loan Fund International (ECLIF) of Switzerland, as well as small loans, all below \$20,000, from local CMACs. As an NGO, AMA did not have access to funding from COFIDE. AMA obtained a letter of guarantee from FOGAPI in 2002 for \$50,000, which allowed it to borrow US\$100,000 from Oikocredit. In total, since this first loan, AMA has received \$100,000 in guarantees from FOGAPI, on a revolving basis, which has leveraged loans totaling \$200,000.

AMA's client base has more than doubled since 2002, from 1,200 clients to 2,800. Its loan portfolio size is currently US\$1.2 million. It has been remarkably profitable, with an ROE over 30%, and an ROA of 9%. AMA has made significant strides in diversifying and scaling up its access to commercial sources of finance. Despite being an NGO, AMA has recently received funding from COFIDE. It has also gained visibility among other international commercial investment funds. As a small institution lending to a market that does not compete with that of other MFIs in the region, AMA continues to access small loans from local CRACs, cooperatives, and EDPYMEs. It is also still receiving soft loans from bilateral and multilateral agencies. AMA has taken its lessons from working with FOGAPI's loan guarantees and has also since negotiated guarantees with Cooperativa FORTALECER, a cooperative MFI in Peru.

DCA IMPACT ON FOGAPI

The DCA re-guarantee benefited FOGAPI in three ways. First, FOGAPI was able to free up its committed resources to issue more guarantees. Second, FOGAPI's profitability increased. By

reducing FOGAPI's guarantee exposure, the agency was able to provision fewer funds in accordance to the regulations of Peru's Bank Superintendency and earn a better return on its capital for the re-guaranteed transactions. Finally, FOGAPI noted that having a USAID DCA re-guarantee helped FOGAPI leverage USAID's reputation with potential clients, which helped the institution to market its guarantees beyond this specific structure.

Similarly, the re-guarantee had a positive impact on MFI borrowers. The FOGAPI guarantees allowed EDPYMEs to access Oikocredit loans through commission-based transactions, rather than tying up their liquidity in cash deposits held at local banks as collateral for loans, which many other lenders were requiring. This was especially important in the context of the aggressive growth of EDPYMEs loan portfolios in step with their recent transformation to regulated institutions. From the perspective of USAID, the re-guarantee structure was effective in its leverage effect. A US\$1 million guarantee was leveraged to place US\$3.9 million in loans to MFIs. FOGAPI has shown interest in seeking additional re-guarantee arrangements with USAID as well as other bilateral and multilateral agencies.

Faced with growing competition from commercial banks that provide guarantees to the MFI sector for accessing funds, FOGAPI should shift toward higher-risk clients rather than compete head-to-head with commercial banks. The DCA re-guarantee was relatively small vis-à-vis the large demand for credit among MFIs in Peru, thus it was understandable that FOGAPI selected some of the stronger and fastest growing institutions when providing guarantees. Today the market has changed, with some EDPYMEs able to access commercial funds from international investors with less rigid collateral requirements than in the past. Some EDPYMEs have also begun to access commercial bank financing, from a few of the country's smaller financial institutions that are not well positioned to lend directly to the MSE sector. These loans have had high collateral requirements. Other EDPYMEs are contemplating capital markets issues. Additionally, COFIDE has shown a continued interest in lending to EDPYMEs with more flexible collateral requirements. As EDPYMEs diversify their sources of funding and types of collateral pledged, FOGAPI could play an important role in providing guarantees to NGOs as well as smaller EDPYMEs, perhaps with a greater rural focus than some of the current borrowers.

DCA IMPACT ON THE MFI SECTOR

With regard to additionality expected from the re-guarantee, it is debatable whether the structure sufficiently met the expectations set forth at its onset. The structure had initially envisioned local commercial banks lending to microfinance institutions, especially NGOs. Commercial banks in Peru, however, were extremely conservative. Those that were willing to lend in the microfinance market were considering the possibility of downscaling into the MSE market themselves, which discouraged them from lending to possible competition. At this point, some EDPYMEs that have recently begun to negotiate with banks for loans have done so only with those banks that have not shown interest in lending directly to the sector. A more aggressive targeting of these banks early on might have been effective in engaging them in the guarantee structure.

Rather than commercial banks, Oikocredit was the primary lender in the re-guarantee facility. When the guarantee was structured in 2002, both domestic and foreign lenders required that EDPYMEs pledge 100%-200% collateral in order to access loans. This reflected in part the limited and non-traditional collateral available to the EDPYMEs, as well as a limited knowledge by lenders of these

relatively new financial institutions. Oikocredit was willing to lend to EDPYMEs with letters of credit and portfolio guarantees instead, and became a more attractive alternative. Oikocredit notes that USAID's willingness to guarantee loans to the sector was an important vote of confidence that engaged it in the sector early on. Oikocredit has not since relaxed its collateral requirements for EDPYMEs as a result of the guarantee. However, in the case of PROEMPRESA, the initial guaranteed loan had a positive impact on the equity side as Oikocredit is taking a shareholder's role as PROEMPRESA transforms into a deposit-taking financial institution.

An important role of the DCA re-guarantee and Oikocredit's corresponding loans was that these began to crack the market for local currency funding. This is especially important for EDPYMEs, which, unlike formal banks, are not permitted to engage in foreign exchange hedging by the Bank Superintendency. Two of the nine loans that were guaranteed under the structure were made in Nuevos Soles. Since then, a growing number of foreign investment funds have been lending to Peruvian MFIs in local currency through a variety of structures.

An important consideration in evaluating the impact of the DCA re-guarantee is the effect of the guarantee on end borrowers. By focusing on the EDPYME sector, the re-guaranteed funds targeted poorer borrowers with loan sizes of approximately US\$800-1000. This is lower than the average loan size of CMACs, CRACs and EDPYMEs as a group of US\$1,400 and significantly lower than the average MSE loan of all regulated financial institutions of US\$3,600. The combined loan portfolios of those EDPYMEs that received guarantees grew fourfold in three years. By consistently and profitably lending to poorer clients, EDPYMEs carved out a niche that was not being met by banks and other institutions. The re-guarantee for AMA, the rural NGO focused primarily at poor women was also extremely beneficial. AMA's average loan size is US\$400. The Oikocredit loan funded an increase in of AMA's loan portfolio of almost 20% as a result.

CONCLUSIONS AND RECOMMENDATIONS

The DCA re-guarantee through FOGAPI had positive effects overall. Most impressively, it was able to leverage USAID's capital almost four times to provide lending for growing MFIs that had limited access to finance. Oikocredit required that guarantees cover 100% of their loans. As a result, FOGAPI complemented its partial guarantee, which was re-guaranteed by USAID, with an additional loan portfolio guarantee for MFI borrowers to cover the remainder. USAID's DCA re-guarantee helped free up FOGAPI resources and provided the FOGAPI guarantees with an additional layer of credibility with Oikocredit. It also targeted the growing EDPYME market, which was lending to low income microentrepreneurs with impressive results. This re-guarantee structure is relatively new for USAID and has shown that there can be significant benefits to this type of structure. Based on the results of this review, a list of conclusions and recommendations, segmented by environmental considerations and structural considerations, follow for the design of future deals.

ENVIRONMENTAL CONSIDERATIONS

- A stable macroeconomic environment and positive legal and regulatory changes play an important role in the commercialization of microfinance. Nevertheless, when access to finance is a constraint, this momentum can be limited. A DCA guarantee can facilitate access to finance and help MFIs build a credit track record. In an environment of rapid expansion of the microfinance industry, this process can be surprisingly quick.
- Bank downscaling can limit commercial bank interest in lending to MFIs, which can be seen as competition for these same banks. Furthermore, banks are more interested in fee-based business with MFIs that can include deposits, foreign exchange transactions and hedging, letters of credit, and syndication and origination.
- When banks do not choose to lend to MFIs for fear of competition, DCA guarantees can target those financial institutions that are not interested in lending directly to the MSE sectors. This targeting can be explicit, offering guarantees through specific institutions. Alternatively, USAID can provide some accompanying technical assistance and support to identify and engage a broad range of commercial lenders into a structure. In the case of a re-guarantee, this is particularly valuable as it familiarizes commercial lenders with the local guarantors and MFI borrowers, and opens possibilities for new transactions that may not require DCA re-guarantees.
- A DCA guarantee can be strategically important in the lifecycle of an MFI's access to capital. In Latin America, and specifically in Peru, where there are strong incentives for MFIs to become regulated financial institutions, it can take a number of years before these institutions can begin to take deposits and can do so successfully. These same institutions often require significant financing as they begin their portfolio expansion. DCA guarantees can facilitate lending to bridge this transition. It can also facilitate structures that are more desirable to borrowers including local currency loans and loans that do not require cash collateral.

STRUCTURAL CONSIDERATIONS

- The experience of the DCA re-guarantee structure through FOGAPI in Peru sheds light onto the benefits and costs of implementing re-guarantees. Where USAID missions are working in an environment where local government agencies provide guarantees to encourage second tier loans, it can be an effective tool to leverage these funds, while targeting USAID's strategic objectives.
- Local guarantee funds targeted to financial institutions are rare in developing countries. When considering replication of this structure, USAID can take varied approaches. In environments where apex institutions or direct government lending compete with the commercial sector in providing credit to the microfinance sector, USAID may consider lobbying these agencies to replace direct loans to stronger institutions with guarantees and second-tier loans that can facilitate local commercial lending to the sector. Further, the experience of a re-guarantee has implications for USAID collaboration with commercial banks offering letters of guarantee to local borrowers. Loan guarantee structures allow MFIs to tie up less capital than deposits and are simpler to manage than other collateral, such as pledging loan portfolios, which need frequent monitoring.
- NGOs can play an important role in providing small loans to the rural poor, whom larger financial institutions are not servicing. Because a re-guarantee structure passes through a dual credit evaluation process, some of these institutions may be screened out. If USAID is interested in targeting rural MFIs or nascent MFIs, it must negotiate these targets explicitly at the onset and provide technical assistance to both guarantors and lenders to improve their understanding and capacity to evaluate these institutions.
- In addition to providing financial leverage, re-guarantees also leverage USAID's resources available for structuring, monitoring and providing other support to the DCA guarantee. If USAID had provided separate guarantees for each of the five MFI borrowers and nine transactions, the origination process and credit evaluation would have been more administratively time consuming and more costly. While this kept the re-guarantee from burdening USAID/Peru with some administrative work, on the negative side, it also limited USAID's ability to monitor progress as FOGAPI reported its activities on CMS with relatively little detail.
- For USAID missions to be more involved, information needs to be shared regularly. Currently, USAID's CMS system does not allow for sufficient information to be entered about re-guarantees that might call attention to a high concentration in one lender, for example. In the case of a re-guarantee, simple reports that provide greater detail would benefit missions.

Going forward, there is scope for additional re-guarantees in Peru. USAID's recent focus on access to finance has been centered on facilitating access to finance for the rural poor, particularly in areas where alternative crop production is being developed. Many MFIs are wary of this clientele, given the risks associated with lending to the agricultural sector. USAID has already negotiated a DCA loan portfolio guarantee to support MiBanco's expansion into this area. There is also potential for an additional re-guarantee through FOGAPI for rural MFIs. FOGAPI itself has begun to consider a decentralizing by opening more offices in the provinces, and sending mid- and high-level management to these offices more regularly. Additional re-guarantee structures may also be considered. Foreign and domestic commercial banks have begun to provide some letters of guarantee for high-end MFIs that are seeking to access external funding. There may be potential for some risk-sharing with through a DCA re-guarantee to encourage these banks to deal with more mid-tier MFIs

ANNEX A: DCA GUARANTEE TERMS

Guaranteed Party	Fondo de Garantía para la Pequeña Industria (FOGAPI) Lima, Perú
Program	Development Credit Authority (DCA)
Type of Guarantee	Loan Portfolio Guarantee; Re-Guarantee of FOGAPI 50% guarantee
Amount Maximum FOGAPI Guarantee (Principal)	US\$2,000,000
Amount Maximum of Loans Guaranteed by FOGAPI (Principal only)	US\$4,000,000
Amount of Re-Guarantee Ceiling	US\$1,000,000
Level of Guarantee Coverage	50% of FOGAPI Guarantee; effectively 25% of loan principal
Term	Three (3) years (extended 4 additional years)
Fees	
<i>Commitment</i>	0.25% up-front fee based on the guaranteed portion of the authorized amount
<i>Utilization</i>	0.25% per annum of the average outstanding principal amount of the two most recent semi-annual reporting periods
Currency	Peruvian Soles and US Dollars