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Can Guarantees Effectively Leverage Financing for SMEs in Low- and Middle-Income Countries?

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Summary

Achieving the Sustainable Development Goals (SDGs) will require significant financing and investment, particularly as growing challenges from climate events highlight the insufficiency of public funds to meet the 2030 Agenda (World Economic Forum 2024). Private capital for low- and middle-income countries (LMICs) surged in recent years, with significant commitments from multilateral development banks (MDBs). However, the financing gap to achieve the SDGs remains sizable, highlighting the need for greater effort to mobilise much larger private capital for sustainable development. In recent years, guarantees have emerged as a key leveraging mechanism. They are designed to mitigate high investment risks to support private capital mobilisation in LMICs. However, despite some progress, guarantees are used sparingly, suggesting considerable scope for increasing their scale, as highlighted by the G20 Independent Expert Group (IEG).

This Policy Brief examines whether guarantees can serve as an effective leveraging mechanism for small and medium-sized enterprises (SMEs) in low- and middle-income countries (LMICs). This is especially so because SMEs remain largely hampered by poor access to finance, despite their key role in providing jobs for the local population and contributing to economic growth. Moreover, in the face of climate change, SME adaptation requires new investments in climate-resistant technologies and clean energies, highlighting the need for additional financing amid severe constraints on access to capital. Guarantees can complement other leveraging mechanisms, further easing financing constraints for SMEs in LMICs. Guarantees can absorb some of the risks associated with investment, offering financial institutions greater security. This added security can, in turn, help improve access to capital for SMEs. On the other hand, they can also help catalyse private sector investment in LMICs. Recognising both the potential benefits and shortcomings of guarantees, this Policy Brief provides the following policy recommendations on how guarantees could be extended efficiently to the SME sector in LMICs.

- Guarantees should be directed at financial institutions to mitigate portfolio risk and actively promote lending to small projects or SMEs in high-risk sectors, particularly those with the potential to generate substantial economic, environmental, or social benefits.
- Complement guarantees with additional measures to improve SMEs' financial management, enhance risk assessment, and strengthen technical capacity through professional training and advisory services.
- Implement partial credit guarantees to require financial institutions to retain a share of the risk, thereby reducing moral hazard and promoting rigorous analyses of borrowers' creditworthiness. Complement these guarantees with conditionalities and monitoring criteria, such as regular reporting, to ensure the incrementality and additionality of guaranteed financing. Enhance the harmonisation of guarantees with other leveraging mechanisms, improve coordination among MDBs and DFIs, and streamline guarantee frameworks to achieve greater efficiency.
- Recognise that guarantees alone cannot address structural vulnerabilities and institutional weakness in LMICs; a long-term commitment from decision-makers is essential to improve institutional and economic performance.

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Introduction

LMICs face a significant challenge in achieving the 2030 Agenda for Sustainable Development and SDGs, with an estimated financing gap of approximately USD 3.9 trillion annually (OECD, 2022). Moreover, in the face of growing climate challenges, additional funding is required to support SMEs – for instance, to adopt climate-resilient technologies and environmentally friendly production methods that reduce their negative environmental impacts. Achieving the 2030 Agenda and the SDGs requires more efficient management of public finances and a strengthened financing ecosystem, catalysing strategic investments that unlock public and private capital. Given the gap in available funding to achieve the SDGs, in 2017 and again in 2023, the G20 countries called for scaled-up investment, inviting greater commitment from international actors and institutions. The amount of mobilised private capital from multilateral development banks (MDBs) surged in 2022, in the range of USD 71.1 billion in LMICs. This represented a 12 per cent increase from the previous year and accounted for approximately 70 per cent of the total (IFC, 2024). However, despite these efforts, the financing gap to achieve the SDGs remains substantial, even as MDBs acknowledge their critical role in mobilisation and pledge to strengthen their contributions.

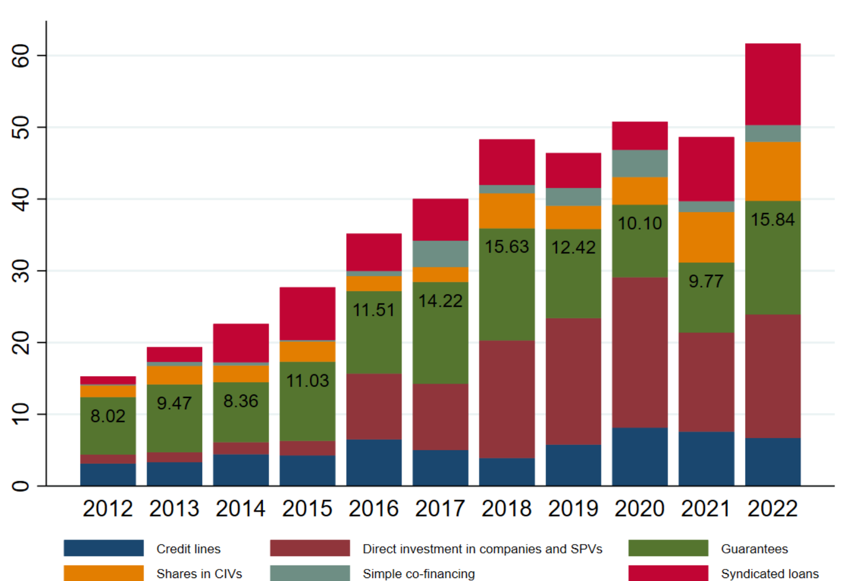
The various risks faced by LMICs, along with institutional weaknesses, adversely affect their business environments, limiting opportunities for investment that could otherwise yield significant socio-economic benefits. To mitigate the high investment risks in LMICs, MDBs use various leveraging mechanisms to support domestic private-sector initiatives and attract additional private capital to LMICs. Blended finance merges private sector funding with concessional funds from public entities and development finance institutions (DFIs). As such, this approach is increasingly being used to address market failures in LMICS and mobilise additional investment for sustainable development projects. Alongside blended finance, guarantees serve as a complementary tool to further de-risk investments. Guarantees help mitigate investment risks by ensuring repayment if a borrower defaults, covering specific risks like political instability or expropriation (OECD, 2013). Guarantees offer several advantages over more traditional MDB lending operations, by reducing the cost of capital, improving conditions for access to credit, or catalysing other investments (see the following section for a discussion on the benefits and challenges of guarantees for development).

Data from the Organisation for Economic Co-operation and Development (OECD) reveal that guarantees have shown a steady upward trend starting in 2012, peaking in 2018, followed by a three-year decline before rebounding in 2022 (see Figure 1).The rise in 2022 is likely due to increased post-pandemic financing needs, and to the strengthening of various initiatives to accelerate private capital mobilisation in LMICs. The total amount of mobilised guarantees averaged USD 11.5 billion over 2012-2022 across all providers, representing approximately 35.34 per cent of total leveraging mechanisms and often being channelled to emerging middle-income economies. On average, the MDBs studied in this Policy Brief (Figure 2) issued USD 6.6 billion in guarantees over 2012-2022 and USD 11 billion in 2022. This represents 30.4 per cent and 29.1 per cent of the leveraging mechanisms for the MDBs considered in this document, respectively. MDB guarantees have been predominantly driven by the World Bank Group – particularly the Multilateral Investment Guarantee Agency (MIGA) – with an estimated USD 5.7 billion in funds mobilised between 2012 and 2022, accounting for over 85 per cent of the total amount mobilised during this period. However, although guarantees have emerged as a key leveraging tool for MDBs in recent years, they are still used sparingly. Indeed, while capital mobilised by the MDBs considered in this Policy Brief almost quadrupled from 2012-2022, the size of guarantees “only” doubled over this period, suggesting that there is still considerable scope for MDBs to expand their scale, particularly in LMICs, as suggested by the

G20 Independent Expert Group (IEG, 2023). More generally, guarantees represent about 5 per cent of MDB finance, although they account for nearly half of the total private capital mobilisation by MDBs (Cull et al., 2024).

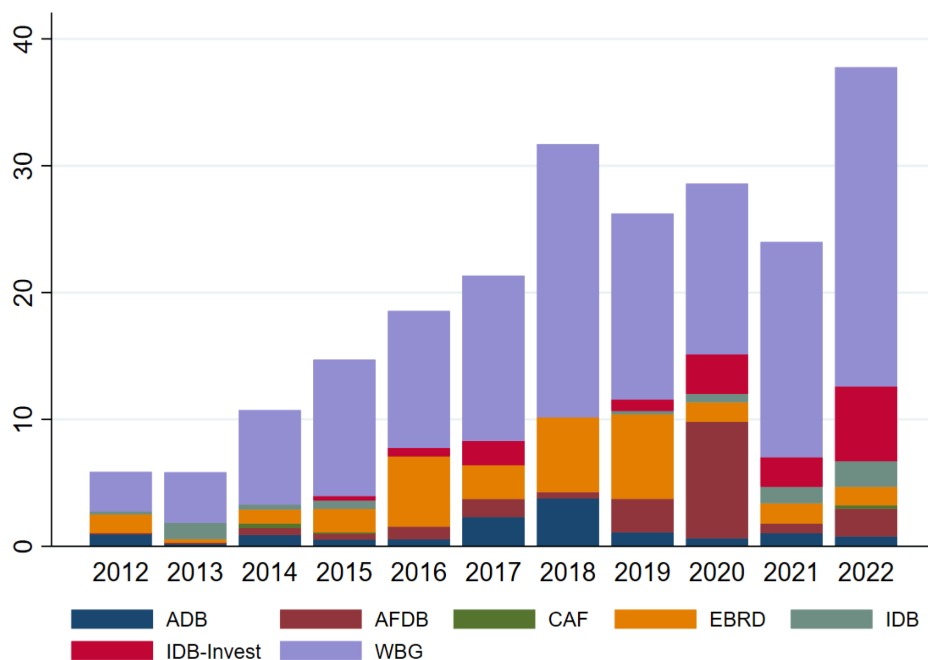
This Policy Brief asks whether SMEs in LMICs are missing potential financing opportunities, notwithstanding the substantial increase in guarantees in recent years. SMEs in LMICs remain heavily hamstrung by poor access to credit, due to their small size and constrained capacities, which exacerbate their vulnerability to default risks or failure (Beck et al., 2006; Wang, 2016; Chauvet & Jacolin, 2017). In addition, political and economic uncertainty in LMICs often discourages investors from making decisions and contributes to the reluctance of financial institutions to provide long-term financing to private borrowers, further restricting financial flows to micro-enterprises and SMEs. The World Bank Enterprise Surveys (WBES) show that almost 24 per cent of the firms surveyed between 2006 and 2020 considered access to finance a major or severe obstacle to their activities. In the same vein, according to the International Finance Corporation (IFC), 65 million firms, representing 40 per cent of formal micro, small, and medium enterprises (MSMEs) in developing countries, face an annual financing gap of USD 5.2 trillion, equivalent to 1.4 times the current global MSME lending volume. In spite of this, SMEs remain a cornerstone for achieving the SDGs, given their critical role in economic growth, job creation, and poverty reduction. Ensuring access to capital for SMEs is, therefore, crucial for enhancing their capacity to support the 2030 Agenda. Guarantees can play a significant role in addressing SME financing constraints in LMICs due to their potential benefits; however, their function as a leveraging mechanism for SME financing has received limited attention in the literature to date. Against this background, this Policy Brief has two main objectives. First, it examines how guarantees can address SME financing constraints in LMICs by facilitating access to credit and capital, while also identifying challenges these guarantees may face. Second, it offers key policy recommendations for efficiently leveraging guarantees to support SMEs in LMICs. The Policy Brief focuses on MDBs as there has been a broad adoption of guarantees by these institutions in recent years, with some engaging exclusively in guarantee-based mechanisms. Importantly, several studies suggest that there remains significant scope for MDBs to further expand their use of guarantees.

Figure 1: Trends in leveraging mechanisms, USD billions, 2012-2022 (all providers)



Source: Author, from OECD data (Mobilised private finance for development)

Figure 2: Guarantees approved by MDBs, USD billions, 2012-2022



Source: Author, from OECD data (Mobilised private finance for development)

Benefits and key challenges of guarantees for SMEs

Main (potential) benefits

Numerous LMICs face considerable socio-economic instability and weak institutions, which significantly hinder their business environments (Bandura & Ramanujam, 2019). Consequently, macroeconomic instabilities and poor institutional quality often deter investors from making investment decisions or entering these markets. Similarly, financial institutions are reluctant to engage in markets perceived as high-risk, such as SME lending. Many opportunities with high potential returns are often rendered unfeasible due to these risks and poor institutional environments. In addition, while macroeconomic and structural factors in LMICs inherently increase the cost of capital, the perceived risks by international markets or rating agencies may be higher than the actual ones, contributing to driving up capital costs. Similarly, the very small scale of investments, information asymmetries in assessing investment prospects, and the vulnerability of SMEs to default risks make them less attractive to the traditional banking sector, thereby creating additional barriers to accessing finance. MDBs have advocated for guarantees as a key leveraging mechanism for mitigating investment risk in LMICs and, ultimately, for promoting private capital mobilisation. The benefits associated with these guarantees can be particularly profound for SMEs, especially given the multiple constraints they face in accessing finance.

First, by targeting specific risks in LMICs (e.g., political risks, expropriation, armed conflicts), guarantees can mitigate the perceived risks associated with investment, thereby offering SMEs and financial institutions greater certainty and security when extending or accessing credit (World Bank, 2009; 2015; Riding, Madill, & Haines, 2007; Chodorow-Reich et al., 2022). The MIGA guarantees provided to Kashf Microfinance Bank in Pakistan under the Small Investment Program (SIP) is a flagship example of guarantees that support microfinance institutions' lending activities to SMEs and the unbanked population. Furthermore, in the face of the growing awareness of climate change, guarantees can help support climate-resilient projects that promote

better adaptation. For sectors such as agriculture, a key provider of employment in many LMICs, efficient and resilient technologies can help boost productivity to meet the growing demand for food and reduce poverty (OECD, 2013). Second, by protecting certain investors reticent to enter risky or volatile markets, guarantees can also help catalyse private sector investment in LMICs, including innovative investment projects likely to improve capital allocation and risk management, technology and knowledge transfer, innovation, productivity, growth, and job creation For instance, according to the IEG (2023), each dollar of World Bank guarantees, on average, mobilised USD 4 of investment financing. Similarly, guarantees can contribute to the development of local financial markets, by encouraging local financial institutions to enter the SME market. Lastly, as mentioned above, while perceived risks in LMICs often exceed actual risks, thereby driving up capital costs, Lee, Betru, and Horrocks (2018) outline that default rates on guaranteed transactions are generally quite low. This suggests that, although the economic and institutional environment in several LMICs is risky and highly volatile, well-designed guarantees targeting promising SMEs can provide a less costly means for LMICs to achieve their development goals. One may expect guarantees to have a greater impact in low-income countries, where financing constraints are more pronounced. However, middle-income countries often benefit from stronger institutional capacity, which may enable more effective implementation. This dual dynamic makes it challenging to predict the effectiveness of guarantees based on income levels.

Key challenges

First, guarantees may not necessarily translate into additional loans for SMEs if they are poorly designed. Indeed, it is possible that financial intermediaries may use the guarantee programme to reduce the risk of their existing loan portfolios rather than extending new loans. The lack of additionality can be particularly concerning when economic confidence is low due to unforeseen risks; when firms increasingly turn to informal financing; or when stringent macro-prudential regulations restrict credit supply. Second, another concern is the risk of moral hazard among SMEs or financial institutions, which could lead to excessive risk-taking or behaviours that jeopardise the successful outcome of the project covered by the guarantee. Third, many SMEs in LMICs do not have certified and audited financial statements on which financial institutions can rely to assess their financial strength and repayment capacity. The lack of skills to carry out feasibility studies to the required standards, along with insufficient qualitative and quantitative information (e.g., complete credit databases and exact models to assess creditworthiness) to evaluate the risks associated with SME projects or their successful completion, represents another significant limitation. Crucially, deploying guarantees requires specific financial and risk management expertise. Consequently, these factors may still deter financial institutions from engaging in SME financing, even when adequate guarantees are in place. This is particularly true as neither financial institutions nor guarantees are designed to address the structural and operational challenges faced by SMEs. Lastly, while MDBs are encouraged to target high-impact projects, identifying the most promising enterprises is a challenge, given the multiple sources of uncertainty, particularly in low-income countries and fragile states. Other factors relating to MDBs' capital structure and their financial and operational policies include additional constraints to extending guarantees, including for the SME sector. Indeed, influenced by rating agency assessments, MDBs are increasingly behaving like commercial lenders, prioritising direct loans over guarantees or treating guarantees as though they were fully funded. Additionally, extending or increasing guarantees can have a direct effect on the liquidity available to MDBs, as guarantees are not backed by immediate funding. This necessitates maintaining sufficient liquidity to cover anticipated cash outflows. Lastly, as MDBs are primarily structured to provide loans – apart from MIGA, which specialises in issuing guarantees –

a significant increase in the use of guarantees would necessitate new organisational arrangements and administrative procedures (OECD, 2013).

Conclusion and main policy recommendations

Even though we should acknowledge that successful and efficient extension of guarantees to SMEs requires additional measures that may be difficult to achieve, depending on each country's context, below is a non-exhaustive list of recommendations.

Prioritise high-impact SMEs with strong financial constraints

Guarantees provided to financial institutions can help reduce their loan portfolio risk, by covering high-risk investment activities or SMEs operating in risky and volatile markets. This may allow SMEs operating in LMICs to benefit from more preferable credit terms, affording them to finance projects that would not have been possible otherwise. Hence, MDBs should work closely with financial institutions benefiting from these guarantees, and support them in targeting high-impact SMEs with strong financial constraints and operating in risky sectors or markets. It is important to maximise the additionality of guarantees, as guaranteed loans are more likely to effectively enhance the performance of firms with the greatest need, compared to those with easier access to credit (Arráiz, Meléndez, & Stucchi, 2014). Analyses based on the financial performance of firms, the target market, or quantitative tools based on risk scores can provide important information on the potential economic, social, and environmental impacts of the project, its strengths, and weaknesses.

Strengthen guarantee programmes through enhanced monitoring, conditionalities, and risk-sharing mechanisms

MDBs should complement guarantee programmes with strict lending and monitoring criteria, and conditionalities. This implies, for instance, requiring financial institutions to provide regular reports on loans granted under guarantees, and to ensure that funds are channelled to the most financially constrained but also the most promising SMEs (World Bank & FIRST Initiative, 2015). These reports are crucial to help assess the incrementality or additionality of guarantees, and can also assist in reducing moral hazard from financial institutions, especially when paired with contractual agreements or conditionalities on the use of guaranteed funds (Aboojafari et al., 2019). Risk sharing can be another complementary tool in reducing moral hazard. Indeed, limiting the percentage of the loan covered by the guarantee compels financial institutions to hold on to a share of the risk. In this context, partial credit guarantees, which cover only a portion of financial obligations, can be effective in fostering such rigor. Equally important is the need to ensure that administrative mechanisms are transparent, as this enhances the effectiveness of guarantee programmes and builds confidence among stakeholders. Lastly, conducting regular monitoring and evaluation of guarantee programmes allows for adjustments to align with SME performance and evolving needs, while also mitigating excessive risk-taking and minimising resource wastage (Bachas, Kim, & Yannelis, 2021).

Enhance capacity to overcome barriers

The lack of certified and audited financial statements, coupled with limited expertise in conducting feasibility, risk, and financial viability assessments, are major obstacles that may still contribute to dissuading financial institutions from lending to SMEs, even when covered by the guarantees. It is essential to complement guarantees with other measures and policy reforms to

improve SMEs' or financial institutions' skills in financial management and risk assessment. In this context, the African Guarantee Fund initiative is a promising example, as it provides partial credit guarantees to financial institutions to reduce the risks associated with lending, while also offering capacity-building programmes to its partner financial institutions, helping them better manage risks when financing SMEs. Additionally, policymakers should intensify their efforts to assist SMEs and/or financial institutions, by providing greater technical support, including staff capacity building through vocational training and advisory services.

Promote coherence, streamline processes, and enhance complementarity between guarantees and other financial instruments to maximise their effectiveness

In addition to traditional bank financing, there is a wide range of instruments available to facilitate access to finance for SMEs, including blended finance, financing via microfinance institutions, capital markets, private investors, or participatory financing platforms (Beck & Demirguc-Kunt, 2006; Abraham, Schmukler, & Abraham, 2017; Sommer, 2024). Regulatory reforms and measures that improve SME management, encourage formalisation, enhance financial transparency, and support skills development for managers are equally crucial in creating an environment that enables easier access to finance. Guarantees should complement these tools, requiring strong harmonisation among MDB-mobilised leveraging mechanisms and improved alignment of financing with national or sectoral policies to ensure coherence. Additionally, better coordination among MDBs and large-scale partnerships with other DFIs are essential for sharing risks and harmonising guarantee approaches. Indeed, the guarantee landscape of both MDBs and EU institutions remains confusing and inaccessible, underscoring the need for simplification. Improved coordination among guarantee-issuing institutions and genuine commitment from stakeholders are crucial to enhance the effectiveness of guarantees but also to ensure they contribute to development outcomes. Another important aspect relates to MDBs' liquidity availability: the extension of guarantees within MDBs should be cautious, ensuring they maintain sufficient liquidity to cover unexpected cash outflows. Lastly, although this Policy Brief primarily focuses on MDBs, the recommendations may also apply to public institutions and DFIs that issue guarantees or equivalent products to mobilise private capital in LMICs. Notably, alongside MDB-issued guarantees, those provided by bilateral DFIs should function as complementary tools.

Address institutional challenges to promote long-term development

Guarantees cannot address the underlying challenges faced by LMICs, particularly the structural issues and institutional weaknesses that hinder their business environments. However, they can provide significant benefits, such as improving access to capital for SMEs and catalysing additional investment. A sustainable, long-term solution to mobilising private capital and attracting foreign investment to LMICs must be grounded in domestically driven reforms and structural improvements. Achieving this will require concerted effort and strong commitment from policymakers to enhance both institutional and economic performance. Key priorities include promoting good governance, establishing strong regulatory frameworks, ensuring socio-economic stability, investing in quality infrastructure, and enhancing human capital.

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