External Investment Plan – Further contribution of EU Member States' Financial Institutions ('MS FIs') following the EUBEC policy group meeting of 29 July 2016

4 August 2016

The MS FIs support, in line with the European Council conclusions, the idea of the External Investment Plan (EIP). We believe the EIP provides a unique opportunity to further shape a European aid system that is effective in meeting the development challenges of our partner countries while addressing the root causes of irregular migration. Following the first exchanges that already took place at the EUBEC platform and in addition to earlier submissions on 9 June and 15 July we would like to make the following comments for your consideration. In the Annex we provide a few existing examples of MS FI's use of guarantee and insurance mechanisms.

1. <u>Overall background and rationale of the EIP</u>.

   a. Only broad progress on the international sustainable development agenda[1] will effectively create lasting employment and address the root causes of irregular migration.

   b. Given the multiple causes of migration and the complexity of its links with sustainable development, the approach of the new instruments should be flexible, scalable and suitable to local contexts. Therefore, <u>there should be no limitation on eligible sectors under the entire EFSD</u>.

2. <u>Eligible counterparts: there should be two distinct categories of eligible counterparts ("lead" and "co-financing" counterparts).</u>

   a. In order to ensure adequate EU visibility and uphold EU standards <u>the lead financier role</u> in all projects/programs should be entrusted to European Finance Institutions (EFIs) only. Their operations under the EIP are naturally complying in a coherent way with EU policy objectives and EU standards.

   b. Co-financing as well as policy dialogue with the World Bank and other non-European FIs should be possible and even be encouraged under a European lead.

[1] As internationally adopted in 2015: Agenda 2030 & Sustainable Development Goals (SDGs), Paris Agreement on Climate Change, Addis Ababa Action Agenda.

c. More importantly, the co-financing potential with national and regional development banks of partner countries should be tapped into more systematically to mobilize crucial domestic resources and support the private sector locally.

3. Ensuring a level playing field. All eligible counterparts entitled to play a lead financier role (the European pillar-assessed FIs) should have equal access to the EIP instruments.

4. Blending: scale-up volumes and boost effectiveness.

   a. The current operating model for blending is overall fit-for-purpose and has proven its ability to deliver results. The new mechanism should build on this track record. Clear political commitments have been taken to scale it up further[2].

   b. Against this context, we welcome the proposal to develop programmatic approaches in the future setup for blending. This should include the possibility to present entire programs (i.e. a bundle of a number of projects targeting a specific sector or theme). Such programs would allow for more cost effectiveness and produce higher impacts, while there is no need for a dedicated structure such as the establishment of a fund or sub-facility.

   c. Policy-based lending (combining loans with EU grants for direct budget support) is another promising programmatic approach and a new tool to increase policy leverage of EU funding.

5. New Guarantee EGSD.

   a. All eligible counterparts entitled to act as lead financiers (pillar assessed European FIs) should have equal and direct access to the EGSD (i.e. the possibility to propose portfolios of projects for a first loss piece risk coverage or large individual investments for a *pari passu* risk coverage).

   b. All decision-making (approval of such eligible portfolios and individual projects under the EGSD) should lie with an inclusive operational board with Member States and the European Commission having voting rights. EFIs would participate as observers so as to bring in their technical and financial know-how. In the decision making, lessons learned from the investment facilities, such as the utilization of standard application forms and impact markers, should be considered.

   c. The technical and financial administration of the EGSD needs to be organised in such a way as to ensure neutrality and most efficient use of EU funds. To this end, it is necessary to bring in the best available expertise for effective, independent, professional and cost efficient management of the guarantee facility. Therefore, the management of the EGSD, which is a purely administrative role, should -in our view- be entrusted to the European Commission or an independent guarantee manager.

[2] For instance, see announcements of the European Commission at the Addis Ababa conference to mobilize € 100 bn by 2020 through EU blending mechanisms.

The latter arrangement would also facilitate the possibility to get the private insurance industry for future re-insurances on board.

d. Incentives for private sector and additionality. The pricing and invoicing of EGSD guarantee fees need to be further studied so as to set appropriate investment incentives while avoiding market distortions. Our initial preference among the 3 proposed options, presented on p. 7 of the Commission's draft proposal, would be option 3 (flexible and viable approach). Nonetheless, further discussions with the private sector are needed.

e. In order to make best possible use of EC funds, the EGSD should allow for a contingent liability out of the EC budget similar to EFSI and ELM. Hence, EC funds can produce a significant leverage effect as the guarantees lead to real disbursements only in the case of default. A contingent liability is therefore clearly superior to a guarantee fund with paid-in EC funds.

f. Effective capital relief. In order to be effective and attractive especially to the private sector, the guarantee has to be eligible under current and future regulatory regimes (e.g. EU Capital Requirements Regulation). Moreover in a case of default the EGSD has to provide capital relief on first demand, as well as in an unconditional and timely manner (i.e. within 30 days). Therefore the EGSD needs to ensure liquidity at all times. This can be achieved through a line of liquidity offered by one or several European FIs as a pre-financing exercise until the EC can mobilize funding out of the contingent liability.

g. A minimum share of private co-investment shall *not* be required for each and every project under the EGSD. We fully agree with the aim of maximizing private-sector participation. Yet, a number of strategic investments laying the ground for private-sector involvement will need to be made by government (central or local).

h. EGSD products: MS FIs welcome the guarantee to be used for innovative instruments such as first-loss guarantees (for instance applied to a portfolio or a structured fund), risk capital (for instance for equity or quasi-equity finance) or SME loan guarantees (to develop lending capacity of local banks). However, we would like this guarantee to be used additionally for covering partially the risk of single development projects (e.g. large infrastructure investments). Loan guarantees under EGSD could cover costs incurred by lenders in case of default comprising repayment not only of the loan principal but also due interest, due interest on arrears and the costs of unwinding related hedging operations (such as swaps). The guarantee could also cover costs incurred in cases where the applicable legislation or regulatory framework changes and requires the lender to accelerate or restructure a loan. The guarantee period should be in line with long loan maturities (EFI loans can typically have a 15-20 year maturity).

6. <u>Pillar 2 and 3 – Technical Assistance, investment visibility and policy environment</u>.

a. Technical Assistance directly linked to investments (project-based TA) is crucial to prepare and implement a pipeline of bankable private sector investments and should be part of pillar 1. Such TA should be allocated to lead FIs following the same procedures as investment grants or interest rate subsidies, very much as it is the case in the current blending framework. A separate structure that administrates these TA funds is not necessary and it is not cost efficient.

b. TA required in relation with the new guarantee mechanism EGSD, should be awarded to the lead FIs in relation to the portfolios and individual projects they propose, independently from the envisaged "portal". The portal should be complementary and be able to ensure a fast response to private sector expectations, in a standardised manner.

c. TA funds related to pillar 3 (regulatory framework and policy dialogue) should also be available to be managed by FIs under the blending mechanism (pillar 1) to finance projects that have the objective of improving the investment climate (policy-based lending initiatives, dedicated projects/programs or components thereof). Eligible FIs will tender and award these to qualified experts in a transparent manner, thus ensuring cost-efficiency and accountability while getting the best available expertise in the market.

d. Capacity building, related to both public and private local sectors, is required as it will ensure the technical quality of the future projects, reduce the risk perception of the private sector and enhance transparency and accountability of the actions taken.

All in all, MS FIs welcome the External Investment Plan and stand ready to contribute with their financial capacity, combined expertise, wide network and close relationship to project partners, as well as to national, regional and commercial banks. EIP with its boost in funding and its new guarantee mechanism gives EFIs the possibility to scale-up their financing efforts and at the same time represents a strong incentive to further promote innovation and involve the private sector. Some innovative project examples that we see fit for EIP are sketched out in the Annex.

MS FIs remain available for further discussion in particular on technical aspects.

Annex: A few examples of MS FI's innovative use of guarantee and insurance mechanisms

AFD's ARIZ and EURIZ guarantee programs boost commercial bank lending to small businesses

Building on its successful ARIZ guarantee programme to develop local commercial bank lending to small businesses, AFD is currently partnering with the European Commission and SIDA to develop an up-scaled approach (EURIZ). EURIZ aims to target the financially underserved MSMEs in the ACP countries (green business, small-scale agriculture, women-owned MSMES…) and in the least developed countries more widely.

MSMEs play a major role in the sustainable development process everywhere and in particular in developing countries. They give communities greater access to essential needs, reduce poverty through job creation and revenue generation. However, in emerging markets, access to financial services for MSMEs remains severely constrained due to the high level of risk perceived by the banking sector. Lending to MSMEs is riskier because these enterprises are usually younger, less structured and rely on the local economic system. Whereas banks are still the main source of formal funding across the region, very few MSMEs actually have access to bank credit and even less to long-term lending; around 60% of loans in SSA have a maturity of less than one year. MSMEs in the region need alternatives to the current short-term debt financing options being offered. Therefore, there is a significant need for more specialised and adequate investments vehicles responding to MSMEs effective financial needs.

Risk sharing instruments are a step forward. They serve basically three purposes: (i) They enable to segregate an investment between riskier and less risky components, thereby lowering the required threshold for private investors in terms of risk appetite. (ii) They help mobilize local currency resources. (iii) And by offering to share new risks they encourage financial intermediaries to grow in that field. Risk sharing instruments offer a lot of flexibility and enable to incorporate some well-designed, transparent, non-price incentives to ensure that the partner intermediaries focus on areas which are real acute priorities.

AFD designed ARIZ risk-sharing facility as one of the financial tools to address this constraint and give SMEs easier access to financing from financial institutions. ARIZ helps financial institutions to partially cover their SME risk and thereby help them develop their loan activity for micro-enterprises, SMEs and microfinance institutions (MFIs). In case of default of payment by the company, ARIZ shares the losses with the financial institution. ARIZ can benefit to eligible financial institutions either through **single deal guarantee scheme** allocated on a loan-by-loan basis or through **portfolio guarantee mechanism**. ARIZ portfolio guarantee mechanism allows 50% of eligible loans allocated by the bank to be systematically guaranteed if they respect AFD's exclusion list. Eligibility criteria include 1 to 7 years loan maturity, 10.000 to 300.000 EUR loan amount, up to a pre-defined portfolio guarantee amount. **AFD has established an ARIZ partnership with over 100 financial institutions. The mechanism is available in 39 countries** in AFD's geographical areas of operation, mainly in West and Central Africa (80%). AFD has also been involved in structuring regional guarantee funds, such as the GARI in cooperation with other IFIs, or local guarantee funds, such as in Madagascar or in the MENA region (SOTUGAR in Tunisia and in Morocco).

For more detail see:
http://www.afd.fr/home/outils-de-financement-du-developpement/garantiesAFD

Climate Insurance Fund (CIF)[3]

The overall objective of the Climate Insurance Fund (CIF) is to contribute to the adaptation to climate change by improving access to and the use of insurance in developing countries. The specific objective of the fund is to reduce the vulnerability of poor, and vulnerable people in low-income households and in micro, small and medium enterprises (MSME) to extreme weather events.

CIF has been able to forge Reinsurance Business Partnerships (RBP) with the leading reinsurance firms of the world: Swiss Re; Hannover Re and Munich Re. Through the RBP CIF's investees can access re/insurance underwriting, capacity building for scaling-up, and to industry contacts.

The Climate Insurance Fund will provide financing (equity, mezzanine and debt) to qualified insurance and reinsurance companies, as well as to other companies active in the value chain of insurance and reinsurance, based in ODA recipient countries that offer or wish to offer insurance solutions for extreme weather events and natural catastrophes and/or agricultural insurance.

In addition to financing, the Fund provides technical assistance for institutional strengthening and/or product design. The Technical Assistance Facility (TAF) of the Climate Insurance Fund will in particular provide product development support and institution building, thereby increasing outreach and reducing risks at partner insurance institutions.

BMZ has provided seed funding of more than USD 60 million for investments and about EUR 17 million for the TAF and start-up premium support. Since its first investment in September 2015, 50% of the fund's assets have been invested. The CIF manager expects the fund fully invested with its current volume in the first half of 2017.

[3] Under the G7 InsuResilience Initiative the CIF has been set up by KfW Development Bank on behalf of the Federal Republic of Germany, represented by the Federal Ministry for Economic Cooperation and Development (BMZ). The Fund commenced its business activities in January 2015. For further information see: www.climateinsurancefund.com/

REGMIFA – Regional MSME Investment Fund for Sub-Saharan Africa

REGMIFA is an investment fund to promote economic development and prosperity as well as employment creation, income generation and poverty alleviation in Sub-Saharan Africa through the provision of demand-oriented financing to partner lending institutions serving micro, small and medium sized enterprises (MSMEs). Unlocking the potential of local capital markets is a priority for its investors.

REGMIFA was initiated at the June 2007 summit of the G8, held in Heiligendamm, Germany. KfW, supported by the German Ministry for Economic Cooperation and Development (BMZ), has taken the lead in progressing the further development of this initiative in close collaboration with a group of other development finance institutions as AECID and AFD, among others.

REGMIFA is a debt fund which focuses on refinancing regulated and non-regulated microfinance institutions, local commercial banks and other financial institutions (each a Partner Lending Institution or PLI), which are established in Sub-Saharan African countries and serve micro, small and medium enterprises. The gross asset value of REGMIFA exceeded 150 M USD at the end of 2015.

Its principal products are local currency fixed interest rate senior loans. Other products are subordinated debt, term deposits and guarantee schemes, the majority of which is delivered in local currency.

As a Public-Private Partnership aimed at establishing a vehicle that holds funds from public and private investors, REGMIFA is structured as a multi-layer fund which reflects the risk/return requirements of its investors. To meet these requirements there are three Shareholder classes (A, B, C) and two Noteholder classes (senior and subordinated), each share and note class having its own risk profile and targeted return. The C-Shares form the foundation of the capital structure. They are primarily subscribed by Donors and comprise a mandatory minimum of 33% of REGMIFA's total assets. In addition to this core quality, by representing the first loss tranche layer, they provide an appropriate cushion to investors that contribute to REGMIFA's development impact by underwriting A-Senior and B-Mezzanine Shares and Senior and Subordinated Notes.

For more detail see: http://www.regmifa.com/investment-fund/capital-structure