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Discussion Paper

Directed Lending: Current practices and challenges

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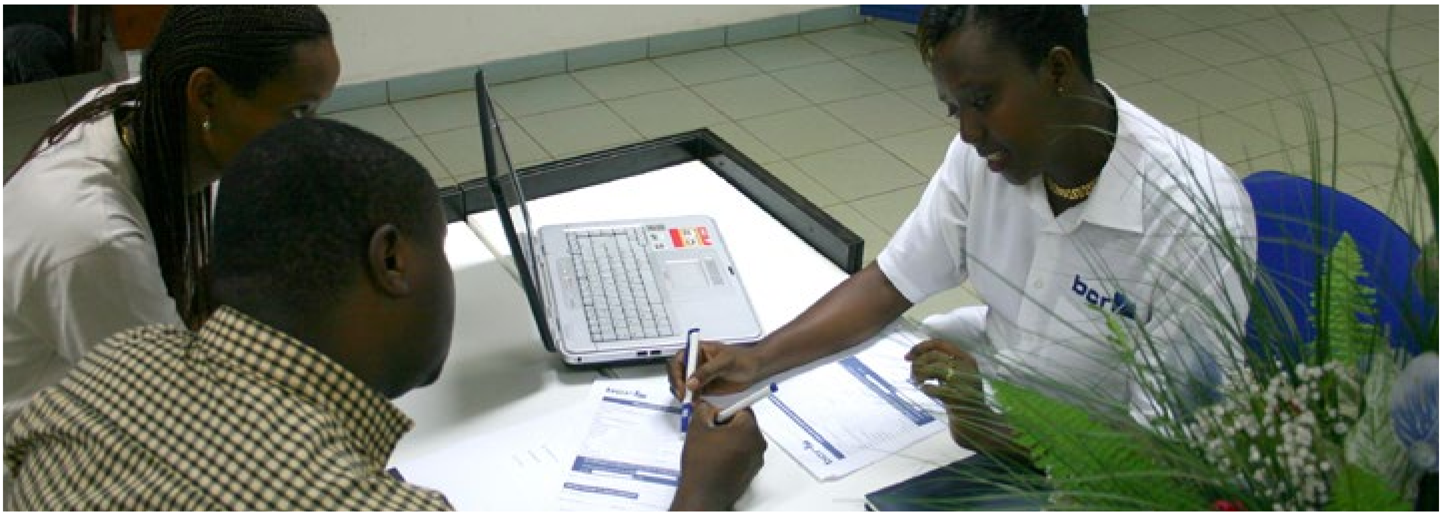

Executive summary

- Development finance institutions (DFIs) increasingly provide committed term loan facilities to financial institutions for on-lending to targeted client segments. This "Directed Lending" is aimed at increasing the development impact of the funding that DFIs provide to financial institutions. Earlier this year, CDC commissioned the consulting firm GBRW to conduct a study of the practices major DFIs have adopted in Directed Lending.
- Directed Lending facilities typically target small and medium-sized enterprises (SMEs). Gender-based lending and green finance have also become two important themes of Directed Lending.
- To enhance their impact, Directed Lending facilities may also include features or "building blocks" which can be combined as required. These include technical assistance, financial incentives for the financial institution receiving the loan (such as discounted interest rates or risk sharing agreements) and for the targeted end beneficiaries (the "sub-borrowers").
- Directed Lending facilities create special challenges for DFIs in selecting intermediary financial institutions, monitoring their compliance with the terms of the facilities and measuring the ultimate development impact.
- Selecting the right intermediary institution is important for the success of the facility. The intermediary should have a strategic commitment to the targeted client segment, demonstrate the intention to make the line of business sustainable and demonstrate the capability to effectively manage and report on the portfolio of sub-loans. The provision of technical assistance to the financial institution to build or improve its capacity to serve the targeted segment is often an important component of Directed Lending. Transformative technical assistance is nevertheless often complex to implement and expensive.
- Banks typically aggregate the funding they raise in order to more efficiently allocate it to their lending operations in a range of customer segments. This "fungibility" of funding can make it difficult to track the money supplied by a Directed Lending facility to the portfolio of loans to the targeted sub-borrowers. The impact of the facility may be monitored through the provision of a list of eligible sub-loans (e.g. when the number of sub-borrowers is not too large) by observing the growth of the bank's lending portfolios. Neither of these approaches constitute a perfect solution, and the risk to impact needs to be mitigated.
- To assess the development impact of a Directed Lending facility, a DFI may also rely on the measurement of specific performance indicators. The determination of relevant indicators is delicate and information may need to be collected at the level of sub-borrowers.
- A well-structured Directed Lending programme achieves sustainable impact by equipping the financial institution to continue financing on a fully commercial basis once the programme and its incentives come to an end.
- The intended impact can only be successfully delivered with the right balance of incentives and accountability. A DFI should therefore consider sufficiently robust portfolio and impact management mechanisms in the event that a financial intermediary fails to meet its obligations under a Directed Lending facility. In such instance, the DFI can for instance escalate the issue to progressive levels of seniority, withdraw any margin rebates or apply a penalty rate, refuse to disburse further tranches or ultimately press for voluntary or mandatory prepayment.

About the authors

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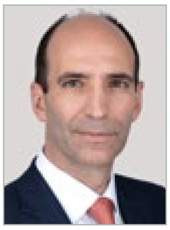
Wasim is responsible for developing the investment and development strategy of CDC's largest sector by Assets under Management. Wasim's role covers CDC's target geographies in Africa and South Asia with a product scope covering Equity, Debt, Guarantees and Funds. Wasim gained his experience in the sector through roles at Credit Suisse and Lloyds Banking Group, and through 20+ projects with Oliver Wyman and Boston Consulting Group. Wasim graduated from the University of Oxford and is a CFA® charterholder.



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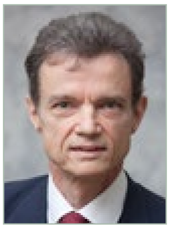
Thomas is an Investment Director in CDC's Financial Services Group, focusing on debt financing to financial institutions in Africa. He has 20 years of banking experience in the fields of mergers and acquisitions, capital markets, and development finance, of which over 15 years covering the financial sector. Prior to CDC, he worked at the European Bank for Reconstruction and Development, investing in financial institutions in North Africa and carrying out policy dialogue with financial sector regulators. Thomas is a graduate of HEC Paris.

Paul Rex, Managing Director, GBRW

Paul has had wide exposure to both developed and emerging markets, having spent 18 years in management positions with two major banks (Chemical Bank, now JP Morgan Chase, and Crédit Agricole) followed by 27 years consulting on banking and financial sector assignments in more than 30 countries. His areas of specialisation include banking strategy, enterprise risk, credit, investment management and specialised lending across a wide range of sectors. Paul has an MA from The Queen's College Oxford and is a Fellow of the Academy of Experts.



Philippe Belot, Director, GBRW

Philippe has 35 years of banking and corporate finance experience. His career was mostly spent abroad, in particular in Eastern Europe and the Former Soviet Union. For 18 years at the European Bank for Reconstruction and Development, he carried out complex financing transactions in the corporate, banking and infrastructure sectors, and participated in the building of market economies after the fall of the Berlin Wall. Since then, he has been advising commercial and development. Since then, he has been advising commercial and development banks with their lending and investment activities. Philippe is a graduate of HEC Paris.

Contents

Acronyms and definitions

ADB	Asian Development Bank
AfDB	African Development Bank
DEG	Deutsche Investitions- und Entwicklungsgesellschaft
DFI	Development Finance Institution (including national DFIs and MDBs)
DL	Directed Lending
EBRD	European Bank for Reconstruction and Development
EIB	European Investment Bank
FI	financial institution
FMO	Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden NV
GCF	Green Climate Fund
GEFF	Green Economy Finance Facility
GIIN	Global Impact Investing Network
IADB	Inter-American Development Bank
IFC	International Finance Corporation
IRIS+	System for measuring and managing Impact developed by GIIN
KPI	Key Performance Indicator
LMA	Loan Market Association
MDB	Multilateral Development Bank
MFI	Microfinance Institution
MSME	Micro, Small and Medium-sized Enterprise
NBFC	Non-Banking Financial Company (India)
NBFI	Non-Bank financial institution
PBI	Performance-based Incentive
Proparco	Société de Promotion et de Participation pour la Coopération Economique
RSF	Risk Sharing Facility
SDG	Sustainable Development Goals
SME	Small and Medium-sized Enterprise
SPV	Special Purpose Vehicle
Sub-borrower	The end user of funds provided by a DFI to an FI under a DL facility
Sub-loan	A loan extended by a FI to a Sub-borrower under a DL facility
Sub-project	A project pursued by a Sub-borrower and financed by a Sub-loan
TA	Technical Assistance

01

Introduction

Development finance institutions (DFIs) increasingly provide committed term loan facilities to financial institutions for on-lending to targeted client segments – most commonly SMEs. Such "Directed Lending" is aimed at increasing the development impact of the funding that DFIs provide to financial institutions in the countries they cover. However, achieving the desired control over the ultimate destination of the funding creates challenges for DFIs in selecting suitable financial institutions as counterparties and in monitoring their compliance with the terms of the facilities. And because DFIs must "look through" the intermediary financial institution, it also creates difficulties in observing the ultimate Development Impact of these facilities.

This discussion paper describes the ways DFIs are now rising to these challenges, after outlining the rationale for Directed Lending facilities and the way they are currently structured. We believe the information provided in this paper will be of interest to the DFIs that provide Directed Lending facilities, to the financial institutions that receive them, and to the donors (including governments and other shareholders in DFIs) who play a role in these transactions. The experience of the large players covered may also be of interest to smaller DFIs considering similar approaches.

1.1 Scope of the study

The findings presented in this paper are the result of an assignment carried out by GBRW Consulting for CDC Group. GBRW's study was based on interviews with nine DFIs in the second and third quarter of 2020, supplemented by a review of publicly available documents and research on DFI websites.

The DFIs interviewed included National DFIs and Multilateral Development Banks (MDBs):

- The National DFIs interviewed are Deutsche Investitions- und Entwicklungsgesellschaft (DEG); Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden NV (FMO); and Société de Promotion et de Participation pour la Coopération Economique (Proparco).
- The MDBs are the African Development Bank (AfDB); Asian Development Bank (ADB); European Bank for Reconstruction and Development (EBRD); European Investment Bank (EIB); Inter-American Development Bank (IADB); and International Finance Corporation (IFC). Within these we can distinguish those with a strong private sector focus (IFC, EBRD and to a lesser extent the EIB) are those that are primarily involved in sovereign lending (ADB, IADB and AfDB[1]).

The three National DFIs are similar in size to CDC (ranging from $6 billion to $8 billion in assets), while the MDBs interviewed range from $48 billion to $614 billion.

1 Although non-sovereign exposures make up 22% of AfDB's development related exposure.

02

What is Directed Lending?

2.1 Definition and history of Directed Lending

While there is no universal definition of directed lending, the EBRD recently described it as "term loans extended to financial intermediaries with a defined use of proceeds."[2] This is the definition we will also use. Directed lending is thus an intermediated form of lending where the DFI can influence the lending policy of the financial institutions it funds.[3] Within eligibility criteria set by the DFI, the intermediary financial institutions remain free in their selection of exposures. They identify the clients, appraise and approve their credit requests, disburse the funds, monitor interest and principal payments and bear the risks of the portfolio. The DFI takes credit risk not on the end borrower but on the financial intermediary (except in the cases mentioned in Section 3.5 on risk sharing and guarantees).

Directed Lending has a long history in development finance. In the 1960s the EIB adopted the "Global Loan" mechanism[4] to fund smaller investments. The mid-1990s saw the IFC making the case for supporting SMEs indirectly through local financial intermediaries that serve the SME market.[5] And in 1999 the EBRD launched the EU-EBRD SME Facility for Central Europe, which established the principle of connecting EBRD credit lines with grant-funded Technical Assistance, a mechanism which was to be expanded in the following years.

Directed Lending facilities have grown in complexity over time. Whereas some Directed Lending credit lines are characterised simply by their use of proceeds clause,[6] an increasing number deploy additional components to deliver the desired development impact. These components constitute the "Directed Lending toolbox", described in Section 3.1.

2.2 Why do DFIs provide Directed Lending facilities?

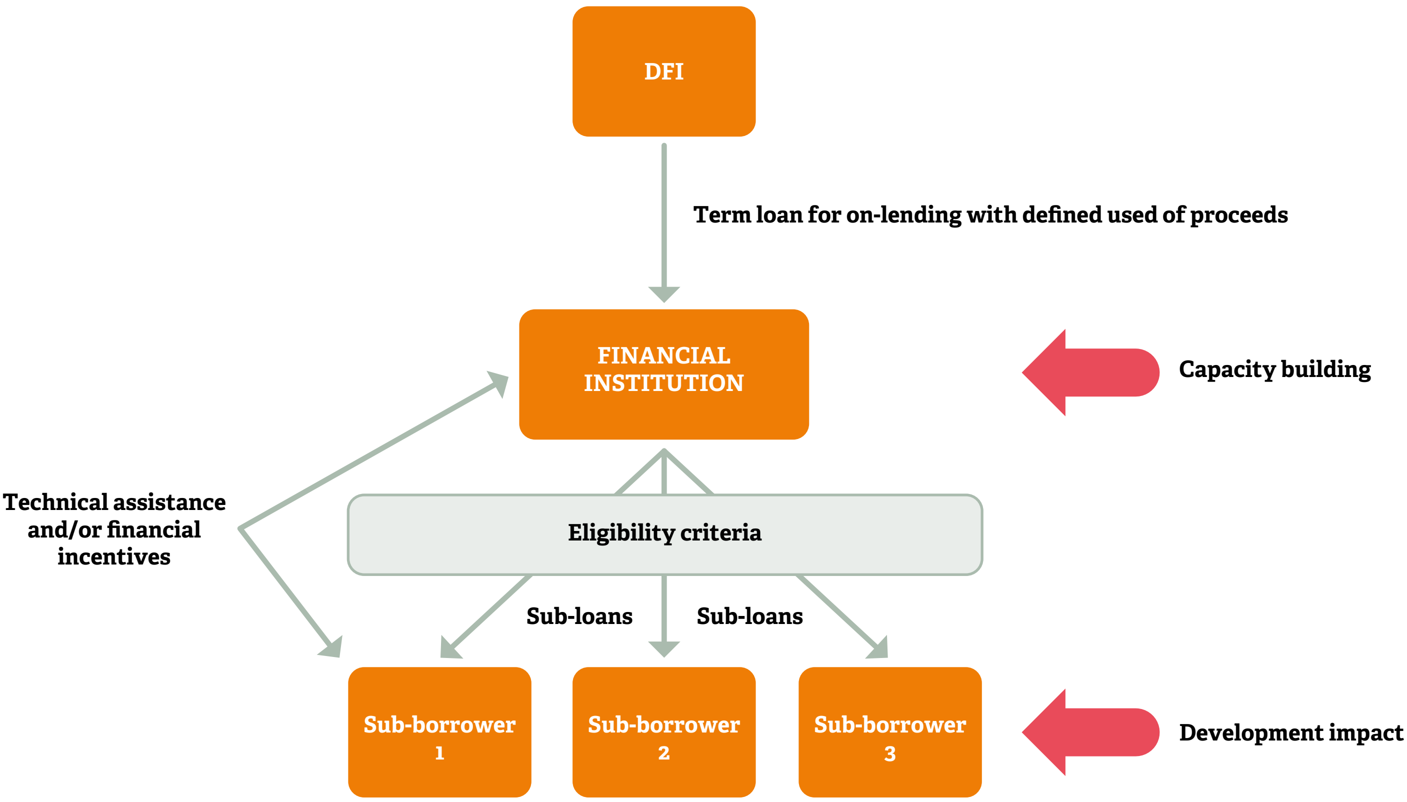
Directed Lending aims to provide financing for projects or customer segments with high development impact. This can be achieved by:

- Providing funding to a local financial institution for on-lending to eligible projects or customers ("sub-projects", "sub-borrowers") in the target segment.
- Building capacity within the financial institution itself so that it can provide the financing required by the target segment.

The typical structure of a Directed Lending facility is shown in Figure 2 below.

2 Credit Lines - Lending through financial intermediaries (EBRD 2018).
3 Proparco uses the term "ligne de crédit affectée" to designate directed lending.
4 The EIB Evaluation Report (2005) defines Global Loans as loans "made to a financial intermediary, which in turn provides an equivalent amount of funding to their smaller clients: the final beneficiaries".
5 See IFC FY95-FY97 three-year business plan as well as "Financing Micro, Small and Medium Enterprises – An Independent Evaluation of IFC's Experience with Financial Intermediaries in Frontier Countries (2008)".
6 The "use of proceeds" clause is a legally binding clause in the loan agreement which specifies to what category of projects or clients the borrowing FI can apply the funds obtained through the loan.

Figure 1: Directed Lending deal structure



Working through a local financial institution enables a DFI to provide financing to sub-borrowers that are too small for the DFI to fund directly. The financial institution provides a deal pipeline through its branch network, access to local currency funding and account management for sub-borrowers that are typically small and medium-sized enterprises (SMEs).[7] A well-structured Directed Lending programme achieves sustainable impact by equipping the financial institution to continue financing on a fully commercial basis once the programme and its incentives come to an end.

Directed Lending is not the only financial instrument that DFIs use to direct credit towards achieving specific development impact objectives. Others include themed bonds (see Section 3.6), trade finance risk sharing through Master Risk Participation Agreements,[8] funded and unfunded risk sharing facilities and investments in credit funds. However, this paper focuses on committed credit facilities to financial institutions which are intended to increase lending to specific sub-borrower segments.

2.3 Why do financial institutions find Directed Lending facilities attractive?

Directed Lending facilities entail extra conditions and reporting requirements for the financial institutions receiving them (see Section 4). They are willing to accept these extra burdens because of the advantages that come with borrowing from DFIs, some general in nature and some linked to the characteristics of Directed Lending:

- **Better access to funding:** DFIs tend to play a countercyclical financing role in the countries they cover, being more active than their private sector counterparts during economic downturns.
- **Better deals:** DFIs have strong credit ratings and higher risk appetites than their private sector counterparts, meaning that they can offer longer maturities at competitive interest rates[9].
- **Technical assistance:** DFI financing is often accompanied by technical assistance. As we see below, technical assistance can help financial institutions to access new market segments and to address wider institutional issues.
- **Other funding and grants:** Directed Lending facilities may come blended with grants or concessional funding from a range of donors and trust funds.
- **The "halo effect":** DFI financing demonstrates that a financial institution has successfully undergone a detailed due diligence process. The financing relationship may also provide the financial institution with access to valuable intellectual resources through DFI contacts, seminars and other events.

7 This category may also be expanded to include Micro-Enterprises (MSMEs).
8 A framework agreement by which a portion of the risk in trade finance transactions is transferred by the originator to another financial institution.
9 The major MDBs are among the few remaining AAA rated financial institutions. National DFIs tend to have the rating of their sponsoring country.

Figure 2: MDB and National DFI financial institution portfolios (USD bn as of 31.12.2019[10])

Name	Total assets	Loans portfolio	Equity portfolio	% of financial institutions in portfolio
EIB	654	529	9	18%
ADB	222	114	2	9%
IFC	99	30	13	41%
EBRD	81	32	6	27%
AfDB	50	28	1	19%
FMO	11	6	2	31%
CDC	9	1	5	25%
DEG	8	5	2	30%
Proparco	8	5	1	42%
IDB Invest[11]	4	2	-	43%

▲ ***Note:*** *The size and range of activity of DFIs shown in this table vary greatly. Figures reported in currencies other than USD have been converted. The last column presents calculations made by GBRW based on the 2019 annual reports of the DFIs concerned. There are differences between DFIs in how sectoral information is reported and therefore these percentages indicate a trend rather than a precise comparison.*

2.4 Importance of intermediated finance for DFIs

Loans to the financial sector represent between 18% and 43% of DFIs' total portfolio[12]. This is due to the importance of the financial sector in the economy and its role in fostering development and financial inclusion.

DFIs do not separately identify directed lending in their financial statements. However, the portfolio of loans to the financial sector is a good proxy because DFIs have progressively shifted their financial sector activity from general purpose loans to directed loans, as explained in the quotes from IFC and the EBRD opposite.

We have eliminated our general-purpose loans to any financial intermediaries; we now ring-fence about 95 percent of our lending to financial intermediaries to ensure that the financing only supports targeted areas, such as projects promoting energy efficiency, renewables, women business owners, or small and medium-sized enterprises.

Philippe Le Houérou, IFC CEO, October 2018

The Bank has actively broadened its use of credit lines to target specific challenges and perceived new opportunities in other areas - such as clean energy... It has become a favoured, even critical, instrument for delivery of new strategic priorities. The original and largest area of focus is green economy lending, initially through Sustainable Energy Finance Facilities (SEFFs) and later Green Economy Finance Facilities (GEFFs). The Women in Business programme, value chain financing and competitiveness support facilities have taken a similar approach.

EBRD Evaluation Department, December 2018

10 IFC: 30 June 2019.
11 IDB Invest is the private sector arm of the IADB Group, owned by its 47 member countries.
12 The ADB has a small private sector activity which explains the low percentage of financial institutions in the portfolio.

03

Key insights of the fact finding study

3.1 DFIs use combinations of the same "building blocks" in their Directed Lending activities

Directed Lending facilities may use several components to deliver the intended development impact. These components constitute the "Directed Lending toolbox".

The core component is a **committed medium- or long-term credit facility** to fund loans to sub-borrowers. The facility is typically in the form of a senior unsecured loan.[13] In contrast to a general purpose credit facility, the facility agreement will include a use of proceeds clause in line with the intended development impact. The Directed Lending agreement will also specify the reporting to be provided by the financial institution on the sub-borrower portfolio.

Technical assistance will often be provided by consultants or the DFI itself to help a financial institution build its capacity to enter new markets or scale up an existing lending activity while managing its risks and profitability.[14] When external consultants are used, their costs are often partially or totally paid out of grant money. Technical assistance may also be provided to the sub-borrowers themselves, in the form of general business advice or more specific advice regarding, for example, the selection of technology that will promote a DFI's green objectives.

Financial incentives for the financial institution may include improved terms in the credit facility, such as a reduced interest margin when performance targets are met, or concessional **risk sharing or guarantee facilities** that reduce the financial institution's credit risk exposure to the sub-loan portfolio.

In some cases, **financial incentives for the benefit of the sub-borrowers** may also be linked to the Directed Lending facility. An example is the EBRD's Green Economy Financing Facility, or GEFF (see box below).

Co-financing by third parties may also be part of a Directed Lending facility. This may be concessional (for example, from climate finance or specialised trust funds) or non-concessional (for example, from impact investors or commercial lenders). The concessional elements are often funded by donors working with the DFIs or by separate, specialised institutions. In some cases the DFIs have access to such resources internally through different concessional "windows" or funds.

The Green Economy Financing Facility

The Green Economy Financing Facility (GEFF) programme operates through a network of more than 140 local financial institutions across 26 countries supported by more than €4 billion of EBRD finance. This has enabled more than 130,000 clients to collectively avoid almost seven million tonnes of CO_2 emissions per year.

In addition to lines of finance, advisory services are available to help participating financial institutions and their clients improve their market practices. The GEFF may offer a cash rebate to sub-borrowers when qualifying investments in clean energy investments are completed and certified.

13 Note that Directed Lending can also be provided in the form of subordinated debt (which can form part of a financial institution's Tier 2 capital) and through bond issuance.

14 CDC has recently published a study on provision of technical assistance to financial institutions: Making effective use of grants and TA to support financial institutions.

The use of each component of the toolbox is assessed on a case-by-case basis. The final mix reflects a number of factors, including the impact objective of the project, the theme of the directed lending activity, the financial institution's requirements and internal constraints to delivery, the eligibility criteria for sub-loans and the resources available to the DFI. Therefore DL facilities tend to be purpose-built and lean towards a more tailored approach to facilitating sustainable delivery of impact.

3.2 A few themes account for the bulk of Directed Lending

As noted, Directed Lending facilities allow DFIs to finance end-borrowers that are too small to serve directly. It is therefore unsurprising that the sub-borrowers targeted for Directed Lending facilities tend to be SMEs. Where the financial institution is an NBFI or an MFI, the range of eligible sub-borrowers may be extended to include micro-enterprises or individuals.

Historically, the first Directed Lending theme supported by DFIs was SME finance in general, albeit with wide variation in the definition of an SME. Other themes have since grown in importance, such as gender-tagged financing, affordable housing, and agricultural value chain financing. Less prevalent are youth, refugees and small municipalities. Green finance, which encompasses climate finance and the related fields of energy and resource efficiency, has become a priority for nearly all the institutions interviewed.[15]

SMEs tend to be the basic component of sub-borrower portfolios. Green and gender-based financing facilities may represent more highly specialised forms of SME lending, or may be "carved out" from more general SME facilities.

There is an effort across the financial industry to standardise the criteria for qualifying sub-borrowers and sub-projects. Such efforts include:

- Definitions of micro-, small- or medium-sized enterprises commonly used include those developed by the European Commission and the World Bank Group, although a number of variants exist at the national level. An enterprise qualifies as a micro, small or medium-sized enterprise if it meets certain criteria based on total assets, annual sales or number of employees. Where this information is not readily available, an alternative approach uses loan sizes as a proxy yardstick.
- Gender-tagged financing is increasingly assessed by reference to the criteria for the 2X Challenge, as outlined in the "2X Criteria Document 2018".
- Climate finance facilities in the form of loans tend to be benchmarked against the Green Loan Principles (GLP) published by the Loan Market Association (LMA). When they take the form of bonds (see below), they should meet the Green Bond Principles (GBP) published by the International Capital Markets Association (ICMA).

3.3 MDBs operate on a larger scale than National DFIs

The interviewed MDBs have a larger balance sheet than National DFIs (as shown on Figure 2), and they avail themselves of more donor and concessional funding. For example, the World Bank group holds a substantial portfolio of donor funds and Financial Intermediary Funds[16] which are used to finance IFC's advisory solutions for private sector clients.[17] MDBs also have more staff or consultants available to support project design, management and monitoring. This scale allows them to engage into more complex projects involving several components of the Directed Lending toolbox simultaneously, or to pursue a "programmatic approach": that is, to contract with several financial institutions in the same country or to build a framework of Directed Lending facilities with common characteristics across many countries.

3.4 Selection of the right partner financial institution is critical

The choice of financial institution is critical to ensuring that a Directed Lending facility delivers the intended development impact. The financial institution must demonstrate a culture and track record aligned with the development objectives for the targeted sub-borrower sector(s). This is a crucial point as the origination of sub-borrowers, the credit appraisal process and subsequent portfolio management will be more resource intensive than "plain vanilla" business lines.

In most countries, banks are the largest and longest established kind of financial institution and thus the financial intermediary most often used by DFIs. Tier I banks are natural candidates for Directed Lending credit lines. They have a higher credit standing and their distribution networks can be important for accessing sub-borrowers. Detailed and reliable portfolio reporting allows them to respond to the higher demands of the Directed Lending projects. This said, practices at Tier II banks may be easier to change in order to achieve greater development impact.

15 There are a number of activities which are have a positive impact on the environment (e.g. environmentally sustainable fishery and aquaculture, biodiversity conservation) but do not have an impact on reducing GHG emissions or adapting to climate change: they are therefore not considered 'climate finance', but can be considered under the broader umbrella term of 'green finance'.

16 According to the World Bank Group 2018-2019 Trust Fund Annual Report, the amount of funds held in trust as of end-FY19 is estimated at $12.1 billion, which finances about two-thirds of the World Bank's advisory services and analytics.

17 IFC's Advisory portfolio has over 783 projects spanning 100 countries and has disbursed approximately $1.5 billion over the past five years.

A key issue for banks is the amount of capital that regulators require them to hold against different forms of lending. This can act as a disincentive to consider new or riskier forms of lending to sub-borrowers, for example when unsecured cashflow-based lending to SMEs is treated more strictly than facilities secured on real estate or financial assets. In these situations, a guarantee or other form of risk sharing with a strongly rated DFI should produce a lower capital weighting and help to address this issue.

Partner financial institutions may also include Non-Bank financial institutions (NBFIs) and Microfinance institutions (MFIs).

Criteria for selection of appropriate financial institutions include:

Strategic commitment

- [ ] A strategy aligned to the objectives of the Directed Lending facility and demonstrated willingness to build capacity and make investments to develop the expertise, systems and products to target the desired sub-borrower segment(s) effectively.
- [ ] A senior management commitment to build (or develop) a sustainable portfolio of loans targeting the chosen segment. In this regard, identifying an internal champion can be instrumental.

Operational capability

- [ ] The ability to produce reporting data and KPIs substantiating the intended development impact.
- [ ] Systems, processes and staff capabilities to handle the targeted segment (or a willingness to upgrade them to achieve this).
- [ ] Distribution channels appropriate for the targeted segment, including both physical and digital options, or a willingness to expand or upgrade as needed.
- [ ] Existing credit products or piloted products that are suitable for the targeted segment or a willingness to tailor an existing product or pilot a new product to a minimum level.

Favourable environment

- [ ] A business environment which makes sustained lending to the target segment viable after the Directed Lending facility terminates.
- [ ] The absence of external constraints, such as regulations, that would discourage lending to the targeted segment.

3.5 Mitigating risks on sub-loans portfolio provides a substantial incentive

In Directed Lending, DFIs are exposed to credit risk from the financial intermediary they lend to, and leave the latter to bear the risk of lending to eligible sub-borrowers. However, financial institutions may consider certain targeted sub-borrower segments to present a high level of risk; or they may lack the experience required to analyse their credit risk and lend to them profitably. While these concerns can be alleviated by providing technical assistance, in some cases a DFI may also need to support a financial institution by sharing credit risk on its sub-loan portfolio. This may take the form of unfunded or funded portfolio risk-sharing facilities (RSFs) or first loss or second loss guarantees. These may be packaged with a Directed Lending facility or provided as a stand-alone credit product.[18]

RSFs and guarantees must be carefully structured to avoid adverse selection or moral hazard. When they are extended on a non-commercial basis, the DFI should ensure that the element of concessionality can be withdrawn once the financial institution has grown confident in that market segment.

In RSFs, DFIs assume a share of losses and remuneration. The DFI commonly takes 50% but can take more when a sub-borrower segment is perceived as high risk, or where it is necessary to provide additional financial incentivisation to the financial institution. The remuneration charged by the DFI for providing risk sharing is normally based on the margin over the rate of interest charged to sub-borrowers less a percentage (or "skim") retained by the financial institution.

Providing guarantees on a portfolio basis is an alternative to RSFs. DFIs are usually reluctant to provide a first loss guarantee, although some donors will provide one or will indemnify a DFI which does so. When provided on a commercial basis, the guarantee can be extended by the DFI itself or an ancillary guarantee fund. The remuneration is based on the underlying portfolio risk as assessed by the DFI.

Sharing risks with a DFI may lead to capital relief for the financial institution concerned. Rules vary in this respect, and the relevant prudential authority must assess the financial strength of the DFI itself.

18 From the DFI perspective, a fully funded RSF would have similar risk characteristics as a DL facility with risk share on the entire underlying sub-borrower portfolio.

3.6 Themed bonds become a new form of Directed Lending

Themed bond issues are becoming increasingly widespread as another form of Directed Lending. Themed bonds are those with a pre-specified use of proceeds by the issuer, including categories such as green bonds, gender bonds and social bonds. The green bond market has grown from almost nothing a decade ago to roughly €660bn in outstanding debt today, and is forecast to hit €2 trillion by the end of 2023[19].

In a number of recent cases, DFIs have worked with financial institutions to structure bond issues with terms that reflect the Directed Lending requirements. The bond may be issued by the financial institution as a private placement to a limited number of investors or as a public issue with the DFI acting as an anchor investor. In some cases, the DFI may subscribe to the full amount of the bond issue as a market deepening exercise.

The key terms applying to Directed Lending through a bond issue will normally be reflected in the bond prospectus, which will also specify requirements for certification, reporting and verification. In the case of a climate-related use of proceeds, bonds would typically be expected to follow the ICMA Green Bond Principles.

One significant difference between bond issues and bilateral loans is that the former incorporate fewer mechanisms for a dialogue between investors and the issuer. Decisions about steps to be taken if an issuer fails to use the bond proceeds as specified may require meetings of bondholders, which are difficult and expensive to organise once a bond has been widely distributed. Where bondholders do not have effective sanctions, concerns have also been expressed that some bonds may become public relations exercises rather than genuine impact investments.[20]

Banistmo's Gender Bond

In February 2019, Banistmo Panama (a subsidiary of the Bancolombia Group) and IDB Invest announced the issuance of the first social gender bond in Latin America, totalling $50 million with a five-year term. This made Panama the first country in Latin America to issue a social bond with a gender focus, aimed exclusively at expanding access to financing for women-led SMEs. Vigeo Eiris, a company specialising in evaluating this type of project, accredited compliance with the international social bond standards established in The Social Bond Principles of the International Capital Market Association (ICMA).

IDB Invest structured the bond and subscribed to 100 percent of it.

19 NN Investment Partners, 14 October 2020
20 For example, Investors probe ESG credentials of bond sellers on 'greenwashing' fears, Financial Times 28 October 2020.

04

The challenges of monitoring Directed Lending

The rationale for Directed Lending facilities – that working through a financial intermediary enables a DFI to finance enterprises it otherwise could not access – also gives rise to the two major challenges it presents to DFIs: namely, ensuring that the funds really are directed towards the targeted sub-borrowers and that the intended development impact is achieved.

4.1 Checking the use of proceeds

The process of tracing the proceeds of a Directed Lending facility from drawdown to sub-borrower might appear straightforward. And it can be when the financial institution is small or specialised in the type of lending aimed at by the Directed Lending facility. But things become more complicated when the financial institution is a large bank, as it usually is.

The difficulty here arises from the "fungibility of money" combined with the fact that banks have multiple sources of funding which they put to multiple uses (see Appendix 1). When a bank's various sources of funding are pooled and then disbursed to a wide range of borrowers, how can a DFI be sure that the funding it has provided through the Directed Lending facility is adding to the financing going to the intended sub-borrowers? Two approaches are commonly taken, although neither fully resolve the issue of fungibility:

- A **name basis or list approach**, by which each individual sub-borrower is identified. This can be used when the sub-loans are large and the process is therefore manageable. It may also be used when some characteristics of the facility, such as providing grants to sub-borrowers, make it necessary to identify them individually. The financial institution provides a list of the eligible sub-loans made during the facility's availability period which can be verified by the DFI.
- A **portfolio basis or portfolio growth approach** by which the financial institution reports on the volume of the portfolio of loans meeting the criteria of the Directed Lending facility. This can be used when the Directed Lending programme has a high number of expected sub-loans, for example, when the theme is SME or gender lending. The growth of the portfolio is an indication of the use to which the Directed Lending funds have been put. More specifically, the DFI may seek to monitor:
  - The growth in the portfolio of loans to eligible clients in excess of the financial institution's projected growth for this segment in the absence of the DFI's funding.
  - The relative growth of other segment portfolios.
  - The growth of the financial institution's total loan portfolio.

4.2 Reporting and the measurement of development impact

Directed Lending credit lines are not ordinary DFI investments because of the need to "look through" the intermediary institution to observe the results achieved with sub-borrowers. The monitoring approach for Directed Lending therefore combines the regular reporting that a DFI would impose on a financial institution client with performance indicators that measure the fulfilment of commitments made by the financial institution and the intended development impact of the facility. This requires the financial institution to agree appropriate reporting requirements in its contracts with its sub-borrowers.

4.3 Verification

Verification is the action of checking the accuracy of the information provided by the financial institution regarding the use of proceeds, the performance indicators, and the portfolio of sub-borrowers and sub-projects.

The verification of sub-loans will take place ex-post, based on a sample of sub-loans or sub-borrowers from the portfolio reported by the financial institution. This may be carried out by a spot check on the premises of the financial institution, as authorised under the financing agreement.

When donor grants are involved, it may be necessary (depending on donor rules) to organise verification ex-ante – that is, to check that the sub-loans and grants are earmarked for eligible sub-borrowers and sub-projects before their actual disbursement. In this case verification may be exhaustive and require additional resources to complete.

4.4 Evaluation

DFIs evaluate their projects ex-post to measure their achieved impact and the fulfilment of their stated objectives. The evaluation of Directed Lending credit lines may cover the design and features to determine whether their structure was appropriate and the "toolbox" efficient in delivering the intended incentives and impact. This feedback helps to improve the design of Directed Lending facilities in the future. Examples of evaluations carried out by DFIs on their Directed Lending programmes are presented in Appendix 2.

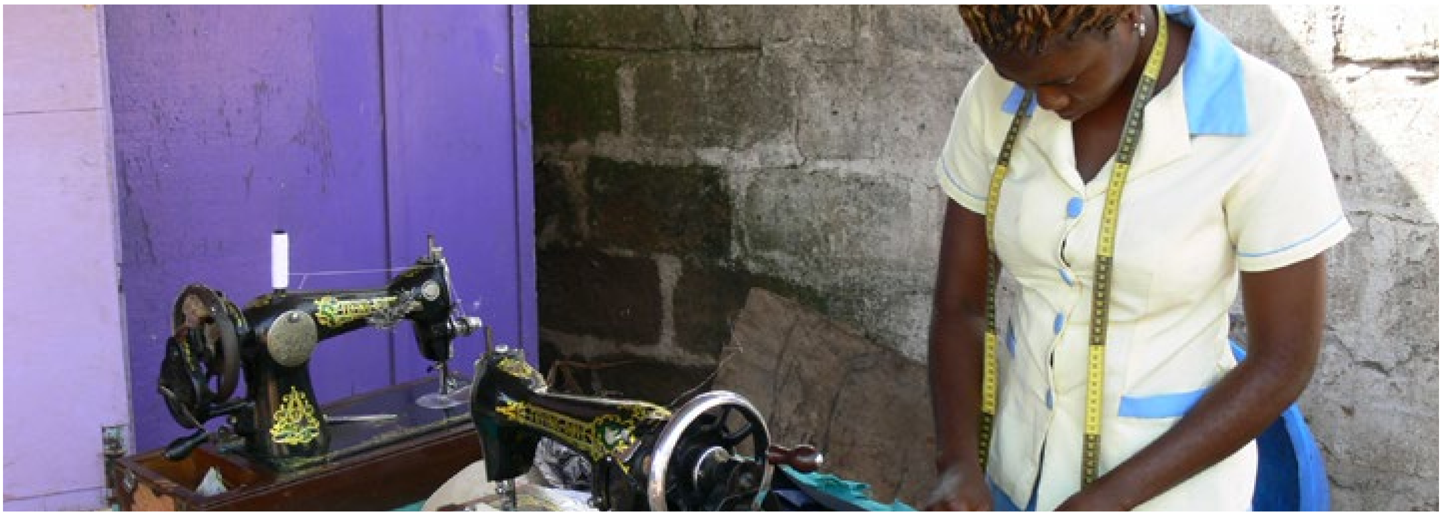
4.5 When a financial institution fails to perform

A financial institution's failure to deliver the new lending to the targeted sub-borrowers could be caused by factors outside of its control – such as competition, economic conditions, or sub-borrower demand. Or it might reflect a conscious change in strategy. Failing to meet the objectives of the facility jeopardises the intended development impact.

When a financial institution is failing to deliver on its Directed Lending commitments as a result of its own decisions or lack of action, a DFI can exert pressure through a tiered approach:

- Escalating the non-performance issue to progressive levels of seniority within the financial institution.
- Withdrawing any incentives that may be provided.
- Refusing disbursement of further tranches of the Directed Lending facility.
- Pressing for voluntary or mandatory prepayment.

The risk of failure to perform against targets can be mitigated by selecting financial institutions with the skills, commitment and resources to implement the project and senior management who have committed strategically to the targeted segment.



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Conclusion

Over the last twenty years, Directed Lending has become one of the key instruments at the disposal of DFIs in their relations with the financial sector. From the initial SME focus, Directed Lending is being applied to an increasing range of themes, such as gender and climate change. This expansion is being facilitated by the ongoing standardization of lending criteria – the Green Loan Principles and the 2X Challenge, being two recent examples – which should also enable more cooperation between DFIs.

To date, Directed Lending has been used mainly by DFIs. However more private sector funding could be mobilised for such transactions. This might involve facility tranches with different maturity structures (an approach seen in other co-financing between DFIs and private sector players) or different levels of "directedness" for the private sector tranches.

The intermediated nature of Directed Lending facilities and the fungibility of money create challenges in identifying the impact of the funds being deployed. DFIs have developed methodologies which allow them to measure their development impact in the context of Directed Lending. This is work-in-progress that will benefit from sharing best practices.

With its growing importance in the activity of DFIs and its application to an ever-wider range of topics and themes, Directed Lending is likely to attract increased interest and scrutiny. This research has attempted to clarify and summarise the main approaches used by DFIs to achieve the intended direction of funds to sub-borrowers and, ultimately, the intended development impact.

Appendix 1: The fungibility issue

Money is "fungible" in the sense that a sum of money is strictly interchangeable with the same sum of money from another provenance. In the case of Directed Lending, this means that there is no direct connection between the funds lent by a DFI to a financial institution and those on-lent to sub-borrowers, even though the amounts might be the same and the two operations might be coordinated and simultaneous.

Historically, the core business of banks has consisted in "financial intermediation" and "maturity transformation": that is, taking in short-term deposits and using this money to make longer term loans. Today, banks have many sources of funds (liabilities) and assets that vary in maturity, currency, interest rate and risk profile. The business model of large banks requires sophisticated asset/liability management, which means that financial assets and liabilities are managed on a portfolio basis rather than transaction by transaction.

It is therefore unlikely that drawdowns of a DFI's Directed Lending facility tranches will match simultaneous drawdowns of multiple sub-loans. In practice, the financial institutions do not segregate the funds received from DFIs and allocate to sub-borrowers money from their treasury pool. This allows speed and flexibility, including flexibility on terms, in responding to their clients needs.

In the same way, repayments of sub-borrower loans are unlikely to correspond to repayments of the DFI loan, and maturity mismatches are likely to occur because sub-loans may have shorter tenors than the Directed Lending credit facility. For this reason "the idea of tracking specific subloans being funded by [DFI] loans is conceptually flawed, given the fungibility of resources in FIs."[21]

It is therefore necessary to develop tools that will allow DFIs to follow the impact of the funds they have lent without impeding the ability of the financial intermediaries to manage their assets and liability in an optimal way.

The fungibility issue: a practical illustration

A financial institution borrowing USD from a DFI makes its loans to sub-borrowers in local currency. Converting the DFI loan to local currency may leave it with an FX exposure and may raise questions over its access to USD when the time comes to repay the DFI loan.

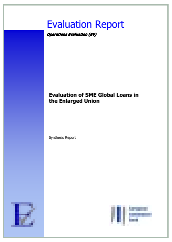
The financial institution therefore retains the DFI funding in USD and allocates it against its portfolio of USD loans to larger clients for asset/liability management purposes. At the same time, it funds the increase in sub-borrower local currency loans which it has agreed to deliver by increasing funding in its domestic market or reallocating resources from other activities.

The Directed Lending facility has generated an equal or greater increase in sub-borrower loans, but there is not a direct flow of funds from one to the other.

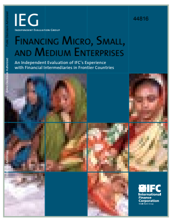
21 Inter-American Development Bank evaluation report: "IDB's Group Work through Financial Intermediaries (March 2016)".

Appendix 2: Independent evaluations of Directed Lending

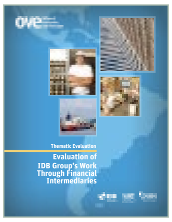
MDBs submit their operations to evaluations by independent experts to measure their impact and the quality of their design. Directed Lending is no exception. Although Directed Lending was not evaluated as such (the term "Directed Lending" was coined only recently), several evaluation reports are publicly available and provide an insight on the performance and challenges of this instrument:



Evaluation of the SME Global Loans in the Enlarged Union (EIB, 2005)



Financing Micro, Small, and Medium Enterprises - An independent Evaluation of IFC's Experience with Financial Intermediaries in Frontier Countries (IFC, 2008)



Evaluation of IDB Group's Work Through Financial Intermediaries (IADB, 2016)

Credit Lines – Lending through financial intermediaries (EBRD, 2018)

Both the EIB and the IFC conclude that that the strategy of supporting MSMEs through creditworthy financial intermediaries has been broadly effective. All reports emphasize the importance this activity has taken in the overall portfolio and its contribution to profitability.

Due to the intermediated nature of Directed Lending loans and the fungibility of money, all reports stress the difficulty of demonstrating a direct linkage between the DFI's loan and increased access to finance at sub-borrower level. The IADB report attempts to address the question by using proxy measures and the EBRD notes the difficulty of tracking the outcomes at sub-borrower level and attributing them specifically to the Directed Lending line.

Because Directed Lending projects have a purpose beyond the mere provision of funding, some reports insist on the need to operate within a clear strategic framework and point out that this has not always been the case in practice.

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