HORUS
DEVELOPMENT FINANCE

ADA

Study on public refinancing mechanisms for microfinance institutions

Summary for the contributing mechanisms

June 2023

39, rue La Fayette - 75009 Paris
T +33 (0)1 53 32 75 75 - F +33 (0)1 53 32 75 76
info@horus-df.com - www.horus-df.com

Context, objectives and methodology

ADA commissioned a study on public refinancing mechanisms for microfinance institutions, in order to capitalise on existing experiences and refine its approach to these instruments. HORUS was appointed to carry it out.

The first stage of the study consisted in identifying its objects. A broad approach has been adopted. It was agreed that the study targeted any mechanism operating on the basis of public resources, offering financial tools to facilitate financing, with the aim of improving financial inclusion (not limited to refinancing microfinance institutions). A list of 17 refinancing mechanisms was established on the basis of criteria aimed at maximising the diversity of the cases studied. 13 mechanisms responded to the solicitation of consultants and were subject to a brief assessment. 4 mechanisms were then selected for in-depth case studies.

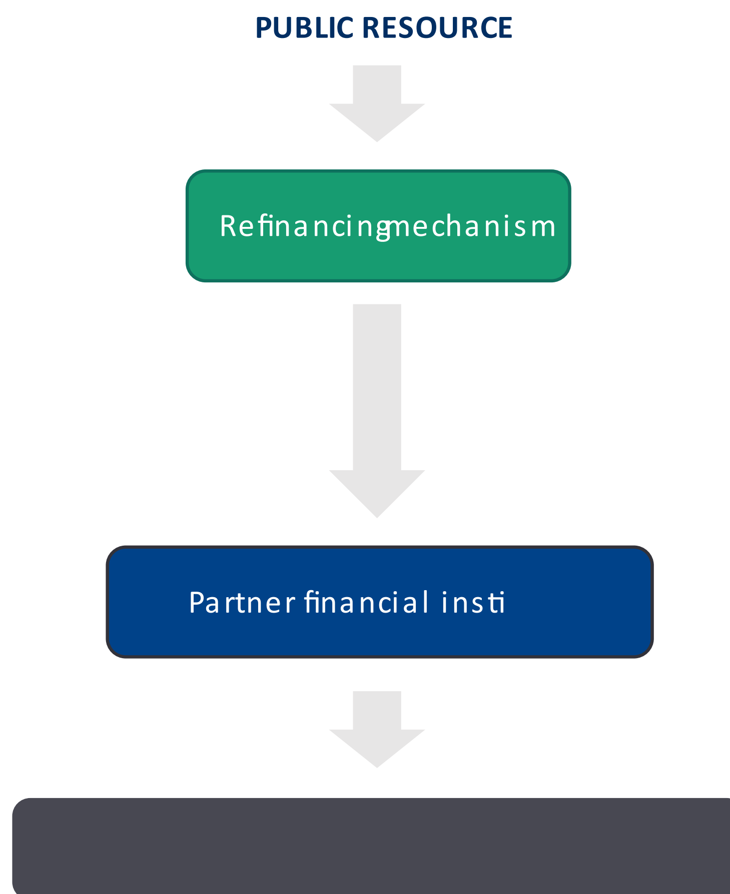

Diagram: identification of the purpose of the study

Lessons were learned from the comparative analysis of the various mechanisms. Lastly, recommendations from the various analyses were made, relating to best practices for the design and implementation of public refinancing mechanisms and the terms of advisory support to be proposed by ADA to such mechanisms.

List of 13 mechanisms studied

The mechanisms studied are the following, and those in bold have been the subject of in-depth case studies.

- National Fund for Inclusive Finance (Fonds National de la Finance Inclusive or FNFI), Togo
- **Agricultural Finance Incentive Mechanism (Mécanisme Incitatif de Financement Agricole or MIFA), Togo**
- National Fund for Inclusive Finance (Fonds National de la Finance Inclusive or FONAFI), Burkina Faso
- National Microfinance Fund (Fonds National de la Microfinance or FNM), Benin
- Investment Fund for Food and Nutritional Safety (Fonds d'Investissement pour la Sécurité Alimentaire et Nutritionnelle or FISAN), Niger
- Development Bank Nigeria (DBN), Nigeria
- **Microfinance Fund (Fonds pour la Microfinance or FPM SA), Democratic Republic of Congo**
- GHAMFIN-RCF, Ghana
- **Business Development Fund (BDF), Rwanda**
- **FSD Africa Investment (FSDAi), Sub-Saharan Africa**
- FONERWA ("Rwanda Green Fund"), Rwanda
- Jaida, Morocco
- European Fund for Southeast Europe (EFSE), Southern Eastern Europe

Analysis of the strengths, obstacles, difficulties and limitations of public financing mechanisms

Mission, Objectives

The mandate of public refinancing mechanisms is not always clearly defined and delineated, and the objectives are not always broken down on the basis of an initial precise analysis of the needs of financial institutions and end beneficiaries.

While all mechanisms aim at promoting financial inclusion, the analysis of public financing mechanisms has led to the differentiation of two approaches of intervention that meet distinct objectives and practices.

- The first approach is to support the development of the private financial sector so that it will eventually become able to sustainably finance currently poorly served segments. This is therefore a transitory support approach, for which the establishment of a cost-effective, financially inclusive financing offer is required.
- The second approach is to offer low-cost financing to end beneficiaries as part of public development policies. The duration of support here depends on the duration of the policy adopted (which may provide for a one-off or long-term offer), and it is not financial profitability, but only the social benefits that are sought.

Other approaches may exist, such as seed financing. It is not always possible to classify a mechanism in either of these categories, as many mechanisms follow both approaches. Some mandates may even be difficult to classify as either approach. However, we believe this distinction is fundamental insofar as positioning on one approach or another will condition differentiated methods of implementation and expected results.

Logic 1: Foster the mobilization of private resources

Logic 2: Distribute subsidized resources

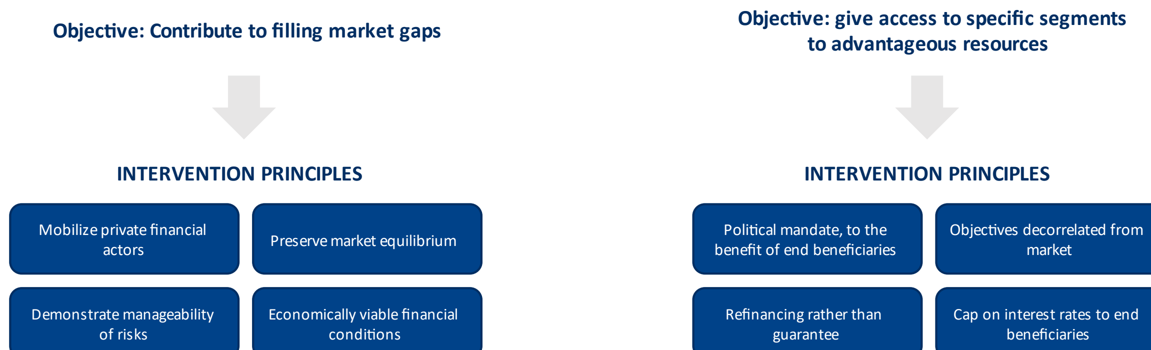

Diagram: identification of the two main approaches to intervention

In the remainder of the study, this typology is used to qualify the analysis and better target recommendations. In addition to this, the countercyclical objective, which is rarely formulated at the time of the launch of the mechanisms, is however essential in times of crisis. Lastly, some mechanisms aim to support the microfinance sector in particular. This positioning, justified in particular contexts (microfinance crisis exit, unprofessional sector, fragmented sector, microfinance institutions operating in a large-sized country and/or under difficult security conditions, etc.), may no longer be justified when the microfinance sector becomes more mature.

NB: The coexistence of the two approaches within the same mechanism is not necessarily problematic, but it raises some concerns, explained below in the "intervention policy" section.

In addition, several mechanisms may exist within the same country. However, the study found a limited number of positioning problems.

Resources put in place

Intervention policy

First of all, it is important to stress that the intervention policy is not always well documented by the mechanisms studied.

Public mechanisms have the advantage, compared to other types of financial institutions, of having a great deal of flexibility in terms of intervention policy. They have the advantage of combining different types of resources and adopting a variety of intervention policies. The diversity of intervention methods, however, can result in risks at the operational level. Four of these risks were identified:

- Risk of lack of clarity of the offer vis-à-vis partners and beneficiaries

- Risk of scattering efforts
- Risk of competition between different intervention policies
- Difficulty to establish a sustainable economic model.

Some refinancing mechanisms combine an intermediated approach with a direct approach. Since each approach has its interests, it may be appropriate, but it must be governed by specific management rules.

The vast majority of the mechanisms studied offer technical assistance alongside financial instruments. It is an asset insofar as it allows for coordination and synergy between the two instruments. This also ensures leverage on the proposed financial resource. The models that appear to be the most sustainable are those for which the AT is financed by dedicated subsidised resources, and is, if possible, managed by a separate dedicated structure.

Only one of the mechanisms studied proposes partial equipment subsidies. It is part of a broader fund that also covers financing for research, technical support and infrastructure, ensuring a coordinated national approach to agricultural financing. Almost all of the refinancing mechanisms studied lend in local currency.

The hedging of foreign exchange risk is not covered by the mechanisms, except in the event of the establishment of subsidised hedging mechanisms.

Governance

The mechanisms adopt a variety of statutes, however, the trend is to move towards an independent legal entity. Regardless of the option chosen, certain fundamentals have been identified to ensure the operational continuity of activities and the trust of partners: Audit and Internal Control Committee, risk management system, independent supervision, separate accounts, etc.

An alternative little explored by the mechanisms studied is management by a third party. Examples exist, however, and can be a source of inspiration.

Several public mechanisms have boards of directors that lack financial engineering skills and knowledge of the local financial sector. However, several mechanisms have strengthened the capacity of their governance through the use of independent directors.

Sources of financing

The interest of national mechanisms is to centralise the financing set up under public policies, which is likely to ensure good operational efficiency and proper coordination of the allocated resources.

Public refinancing mechanisms generally benefit from an initial allocation from the State in which they operate or international lenders, which is added to their own funds when they are incorporated as independent legal entities. The mission and objectives of the mechanism are of course inherently dependent on the partners that finance them. Two of the studied funds offer several share classes. This allows them to adjust the risk/return ratio to the differentiated expectations of various types of shareholders. However, this requires a public limited company status, is only possible if the mechanism

is ready to open its capital to financial partners, and requires minimal knowledge of the financial engineering related to this type of structuring.

Most debt-resource mechanisms have access to subsidised concessional financial resources raised from international lenders. Some mechanisms are able to raise commercial resources. Others have this goal without having yet managed to achieve it. Some mechanisms also raise the subsidy resource from international lenders or the State, in particular for the financing of AT activities or the coverage of certain operational expenses.

Operational management

The first and second approaches have quite different implications in terms of operational management (see diagram at 6.1). Mechanisms pursuing an approach of developing the financial sector require to develop a dynamic commercial approach with partner institutions and to ensure limited processing times. They must also develop a robust approach to counterparty risk presented by their partner financial institutions. For mechanisms to allocate subsidised resources to specific populations, operational efficiency is also required to have the ability to disburse these funds within a short period of time. Monitoring and evaluation capabilities, up to the end recipient, are also crucial for such mechanisms, in order to be able to demonstrate a proper allocation of resources.

The establishment of a monitoring and evaluation framework by the mechanisms and the regular publication of reports on their economic and social performance remain uneven. Few funds have put in place a robust impact measurement system.

One of the mechanisms studied is supported over time to ensure operational management in line with international best practices.

Characteristics of financial products

The mechanisms under review are generally transparent with regard to the terms and conditions applicable to their financing.

Financial products vary according to the objective pursued:

- Mobilisation of the private sector: de-risking tools, refinancing of financial institutions with resources not available on the local market (more advantageous risk policy and interest rates that are enticing but close to market rates), pricing taking into account the level of risk;
- Support for vulnerable populations: subsidised lines of credit with capping of interest rates charged to the end beneficiary.

However, it is not always possible to link the products to one of these two objectives.

Interest rate subsidy can have a perverse effect on the supply and demand for local financing, and is a practice that can be very costly from a scale-up perspective.

Some mechanisms are trying to implement innovative products to move towards greater impact or leverage while limiting market distortions, such as interest rate rebates. On the other hand, several of

the mechanisms studied offer relatively unattractive financial conditions to partner financial institutions, which result in low use of their products. This is generally linked to political desires to display low exit rates to end beneficiaries. The guarantee product is very popular with financiers such as PFIs. However, the guarantee offers studied are struggling to reach their full commercial potential.

Results

Scope/impact

We have defined the potential scope of a mechanism acting indirectly as its ability to mobilise the right partner financial institutions. Its real scope is its ability to effectively reach a significant number of end beneficiaries. The various interviews show that two factors are key to transforming the potential scope of a mechanism into real scope: its ability to raise funds and its ability to commit the resources mobilised.

While the potential reach is good for most of the mechanisms studied, the actual scope is uneven. Mostly, it is difficult to compare and also depends on the maturity of the financial sector.

Scope and impact should not be measured with the same indicators depending on whether the mechanism follows approach 1 or approach 2. Approach 1 mechanisms should focus on their ability to sustainably mobilise private resources to targeted recipients and their additional impact. The measurement of the scope and impact of approach 2 funds is more immediate, as leverage is not necessarily sought and as additionality is more evident given the lower cost of the proposed resource to the end beneficiaries.

Economic sustainability

The mechanisms have different business models that depend on their intervention policies, their offering, their positioning, etc. They do not necessarily aim to generate financial profitability: their objectives are above all social. Never mind profitability, a majority of them are still struggling to ensure their financial sustainability. However, profitability or at least financial sustainability is a condition for the mobilisation of resources and therefore of the scope of the mechanisms.

Efficient use of public resources

Additionality is key to justifying the proper use of public resources through these public refinancing mechanisms. It can be more difficult to demonstrate for mechanisms offering a refinancing offer by following approach 1. The commitment ratio is also a good measure of the efficient use of public funds. Two scenarios have been identified as unfavourable to maximising the use of funds: the risk aversion of a guarantee fund and the shortfall of certain concessional refinancing offers compared to investments in treasury bills. Lastly, leverage is a final measure of the efficient use of public resources. Three opportunities for leverage have been identified:

- The multiplier effect of the guarantee – non-existent in the mechanisms studied, mainly because the structures bearing this guarantee offer do not present the fundamentals required to gain the confidence of the private financial sector and/or their supervisory body
- Mobilising commercial resources alongside public resources
- Structuring methods and tools within partner FIs through a technical assistance offer.

NB: The mechanisms following approach 2 are limited to the 3rd point.

Recommendations for the implementation of public refinancing mechanisms

General approach

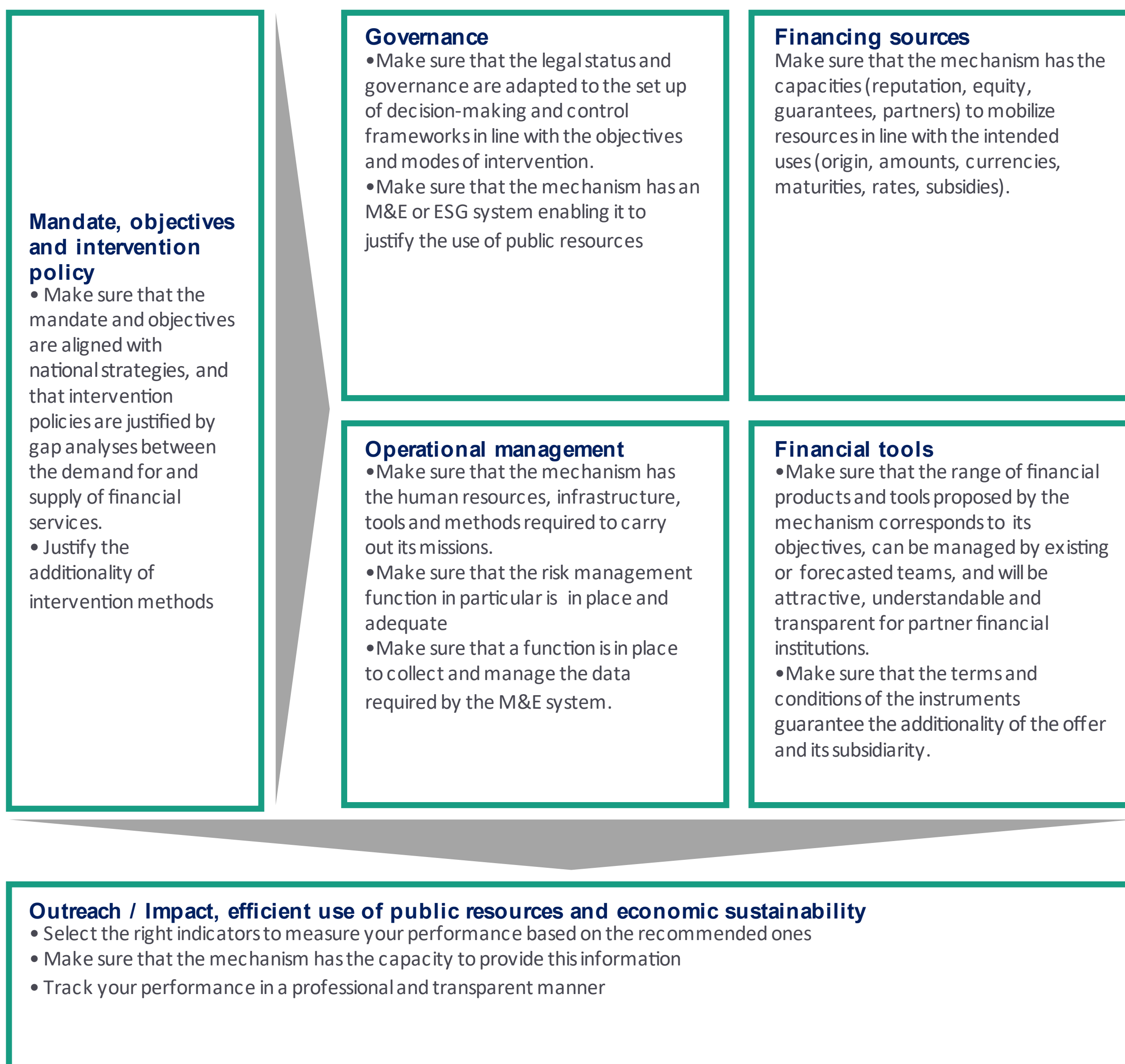

Diagram: recommendations for the implementation of public refinancing mechanisms

Recommendations differentiated by intervention approach

	General recommendations for the implementation of public refinancing mechanisms
Mission, objectives	• Clear objective(s) and mandate(s) based on a precise analysis of the financing that the market does not offer. • Implementation of mandate(s) and objective(s) into clear, accurate and measurable performance measurement indicators. • Whatever the initial objective of the mechanism, in the event of a crisis, the mechanism should operate in the context of a countercyclical intervention, to the extent of the means at its disposal (see below: recommendations for the establishment of a countercyclical offer).
Intervention policy	• Positioning of the mechanism for subsidiarity of the existing financing offer and seeking additionality in the proposed intervention policy. • Limit/frame market distortions and avoid crowding out effects of private sector participants (see terms proposed per objective and per product under 6.1.2, 6.1.3, 6.1.4). • Concentrated intervention policy, at least at the start-up: ensure that the actions of the mechanism are readable by partner financial institutions and financial partners, and avoid the dispersion of the efforts of the mechanism team. • Expand the intervention policy once the first activities are operationally fluid, understood and accepted by the financial sector and the associated risk appears to be controlled. • If the expansion of the intervention policy creates competition between approaches, adopt clear complementary rules to avoid the effects of internal crowding-out. • Open mechanisms to all types of financial institutions • Adopt clear and transparent eligibility criteria for partner financial institutions and end beneficiaries. • Guarantees and lines of refinancing can be offered by the same mechanism, or even used jointly if they are necessary to remove obstacles to financing. • The "financial products"/"non-financial support" mix seems particularly interesting for these mechanisms, which should, where applicable, have a dedicated "pocket", intended to receive the subsidy resource, to finance this type of service.
Governance	• Set up a Board of Directors including members who have relevant professional skills (knowledge of the financial sector and/or sectors to be promoted). • Ideally, establish the mechanism as an independent legal entity. If this is made impossible by political considerations (as an example), the other elements proposed may be used as a safeguard. • Put in place an adequate risk management framework and internal control system, adapted to the size and volume of the structure's activities. • Have an independent supervisory framework adapted to the nature of the activities or, otherwise, request dedicated external audits. • The State's involvement in the mechanism in one form or another is not mandatory but is a good way to ensure that it is aligned with political priorities and possible other public financing offers.
Sources of financing	• Ensure transparency of resources, ideally through separate accounting from the State budget and publication of the accounts. • Regardless of the changes in the mission it involves, the opening of a mechanism to private investors must be made with full knowledge of the facts and ensure that the interests of these investors are well aligned with the interests and the current or expected mandate of the mechanism. • Provide a framework for the retrocession of concession rights, particularly in the event of dividend payments.
Operational management	• The use of external support at the time of the structuring of the mechanism but also over the long term can help ensure operational management in line with the best international standards (outsourced management – EFSE model or institutional support – FPM model) . • Establish a clear monitoring and evaluation framework and regularly publish reports on the economic and social performance of the mechanism.

	• During this implementation, the mechanism should consider the indicators to be taken into account for measuring two key concepts: the additionality and leverage of public resources.
Characteristics of financial products	• The characteristics of the products offered must be attractive to partner financial institutions. • Transparent pricing policy
Non-financial support	• Advisory support to partner financial institutions is a particularly relevant means of mobilising them in a sustainable manner on new targets. • The creation of two independent structures and the establishment of a system to create synergies between the two offers should be targeted. • In the event that the intervention policy provides for the support of the end beneficiaries, favour solutions in partnership with government support services or partner financial institutions, or digital solutions (if appropriate).

	Recommendations for setting up a countercyclical offer
Intervention policy	• The countercyclical approach can justify the introduction of subsidised instruments, which should only be accessible for a limited period of time, to help companies in the real economy on the one hand, and the financial sector on the other hand to emerge from the crisis.
Characteristics of financial products	• Interest rate subsidies are justified in the event that the objective is to support the recovery of companies that have suffered from the crisis. They are not justified, in the event that the objective is to inject liquidity into the market at a time when it is lacking. • The differential between subsidised rates and market rates should not be too large (< 5%, in order to avoid crowding out the private financial sector by proposing a distorted perception of the market and avoid attracting "opportunistic" players). • In the event of a subsidy, the differentiated exit caps must be provided if the mechanism targets both banks and microfinance.

	Recommendations for a mechanism to catalyse the financial sector towards greater financial inclusion
Intervention policy	• Intervention policy developed on the basis of a precise analysis of market flaws. • Silent collateral appears most relevant if the main obstacle identified is credit risk. • Intervention on the recommended line of refinancing if there is a problem with the cost[1] / duration of refinancing accessible by all or part of the country's FIs. • The mechanism should adapt its intervention policy according to the obstacles specific to each type of institution.
Governance	• Include representatives of the financial sector in the governance or even capital of the mechanism. • Form a joint stock company to facilitate the raising of funds of a varied nature. • For the most mature mechanisms, potentially offering several share classes to make the investment attractive to various types of investors.
Sources of financing	• Aim for minimum financial sustainability in order to be able to have leverage on the public resources mobilised (e.g. increase one's ability to mobilise credit resources by presenting cash flow prospects demonstrating an acceptable repayment capacity for a lender). • Mix public and private resources in order to maximise financing volumes.
Operational management	• The commercial approach to partner financial institutions and the establishment of a relationship of trust with them is essential. • Operational management must focus on meeting the expectations of partner FIs, particularly through the implementation of a smooth and fast approval process. • The integration of human resources from the private financial sector is an asset, as it facilitates the establishment of professional operational management.
Characteristics of financial products - Guarantee	• Pricing should take into account the risk level of the institution (portfolio guarantee) or secured loan (individual guarantee). • For sufficiently mature institutions with a satisfactory risk approach, portfolio guarantee, preceded by an in-depth analysis of the institution's credit management capabilities is recommended. For less mature institutions, favour individual guarantees. NB: the individual guarantee is not suitable for microloans. • The guarantee call process must be efficient, clearly documented and transparent. • The guarantee call process must be attractive for the PFI, with at least an advance payment within a short time frame.
Characteristics of financial products - Refinancing lines	• Pricing should take into account the institution's level of risk. • Financing conditions should be advantageous from the point of view of PFIs (slightly below market rates) to make the offer attractive. • No retrocession conditions for end beneficiaries. • Encourage innovation in the proposed financial products to maximise the additionality of the mechanism (interest rebates, subordinated loan, etc.), always on the basis of precisely identified market constraints.

	Recommendations for a mechanism to promote affordable access to finance for vulnerable populations or excluded sectors
Intervention policy	• Favour the intermediated approach to the direct approach for greater efficiency, for greater sustainability (linking end beneficiaries to the financial system) and to limit market distortion effects. • Conditional lines of refinancing, possibly with a cap on interest rates applicable to end beneficiaries.

[1] This could occur in the event that the reluctance of market participants would lead to an overvaluation of the risk premium.

	• If a cap on the interest rates applicable to end beneficiaries is set, the product must target specific categories of populations (e.g. young people entering a new activity, disabled people, agriculture). The interest rate cap is justified either by the observation of lower profitability of the targeted companies due to the business sector or the company's stage of development, or by the positive externalities linked to the investments financed (e.g. climate change mitigation). • If the targeted financial institutions have the capacity to mobilise adequate resources in terms of amount and maturity, the only option available to the mechanism is interest rate subsidy. • It can be wise to explicitly link the objectives of the mechanism to those of national policies, such as a financial inclusion policy or a policy for the development of sustainable finance. This will make it easier to mobilise financing from partners to support these policies.
Governance	• A mechanism to promote affordable access to finance for vulnerable populations or excluded sectors will necessarily be a mechanism with a majority of public resources. The entry of private commercial shareholders will necessarily result in a diversion of the initial mission. • The mechanism will have to be steered by a governance body comprising representatives of public financiers who contribute to it and who will ensure that the management complies with the development objectives. • Bringing other participants into the capital (such as DFIs) can be a way to structure the mechanism and increase the trust of partner financial institutions. • Setting up the mechanism in the form of a dedicated legal entity is recommended, as it allows a better assessment of its business model and offers the possibility of forming a dedicated management team, acting in accordance with professional rules. • Such a mechanism can work entirely on the basis of annual operational subsidies. • The issue of credit institution status ensures risk management and governance standards in line with best practices. However, it is not the only option possible and must be examined on a case-by-case basis, in particular with regard to the possibility of mobilising capital in accordance with the regulations and with regard to other prudential rules, which may, where appropriate, not allow the mechanism to commit itself to the levels of risk it is willing to assume.
Sources of financing	• The mechanism must capture sources of financing from various public participants (ministerial departments, etc.) and projects while promoting a standardised policy of intervention, for the proper coordination of approaches and various financial instruments. • The mechanism is primarily refinanced with subsidised resources (subsidies, concessional lines of credit). • Due to its purpose, such a mechanism could require recurring operational subsidies.
Operational management	• The mechanism must be able to ensure effective monitoring of disbursement levels and compliance with eligibility criteria by partner financial institutions, supported by a robust reporting system. • In particular, the mechanism must have the capacity to collect data to inform its scope/performance, or even an impact measurement mechanism.
Characteristics of financial products	• The wider the category targeted by subsidised products (e.g. women), the more the differential between the subsidised rate and the market rate must be reduced (< 5% seems a reasonable differential to reduce the cost of credit to end beneficiaries without risking creating a bad perception of the cost of credit among borrowers and/or attracting opportunistic participants. 5% could represent a reasonable maximum of the "risk premium" estimated by financial institutions when setting their interest rates.) • The interest spread to the benefit of partner financial institutions must be calculated to enable them to cover their risk cost and operational cost and generate a reasonable positive net margin. • Differentiated exit rates must be capped if the mechanism targets both banks and microfinance, whose intermediation costs are not comparable.

Selection of performance indicators

	Performance indicators (financial and operational)
Potential scope	• Number of partner financial institutions/number of financial institutions in the country • Number of financial institutions that have requested the mechanism over the past year, change in this number over the past three years • Market share of partner financial institutions • Cumulative volume of available resources, change over the past three years
Actual scope	• Number of end beneficiaries, change over the past 3 years • Number of approvals/commitments, change over the past 3 years • Volume of approvals/commitments, change over the past 3 years (to be examined if possible by partner financial institution) • Committed resources/available resources
Economic performance	• Product evolution over the past three years • Change in net profit over the past three years (if independent legal entity) • ROE, ROA (if independent legal entity) • % income from investment activities
Operational efficiency	• Number of employees / Amounts committed (to be analysed critically in relation to the average amount committed) • Processing time for a file
Additionality	• % of first-time borrowers • % of “risky” loans among borrowers (certain categories of populations, certain sectors, certain regions) • % medium/long-term loans
Indicators specific to the refinancing activity	• Non-performing loan rate • Loan loss rate
Indicators specific to the guarantee activity	• Cumulative amount of guarantee calls during the year/Commitments in progress • Length of processing of a complaint • % of complaints refused
Indicators specific to the technical assistance activity	• Number of beneficiaries • Number of training courses completed • Amount disbursed/amount allocated

Recommendations to governments for effective coordination of mechanisms at the national level

The recommendations below are in addition to the recommendations for implementing the mechanisms, but more specifically aim to propose avenues to governments to ensure the effective coordination and optimal operational efficiency of public refinancing mechanisms.

Recommendations for effective coordination of mechanisms over time

Objectives

- Coordination of mechanisms amongst themselves: ensure funds don't compete with each other, encourage synergies between the proposed tools, make clear and transparent offer to partner financial institutions and end beneficiaries.
- Coordination between mechanisms and the country's financial sector: Ensure that intervention policies are justified by analyses of gaps between demand and supply of financial services, that the mechanisms offer subsidiarity vis-à-vis the supply proposed by the private sector and that they have clear additionality (see more elements in 6.1.1, 2 and 3).
- Coordination between mechanisms and sectoral strategies/policies: Include mechanisms in national strategies/policies.

Resources

- Centralise the coordination of mechanisms at the Ministry of Finance, which should be consulted prior to the implementation of any new mechanism and, if possible, the participation of a representative of the Ministry on the Board of Directors of all the mechanisms put in place locally, whether by the State or by lenders.
- Create a national consultation system, led by the Ministry of Finance and bringing together all stakeholders, aimed at coordinating interventions, meeting on a monthly basis, for example.
- Draw up a reference document on financing mechanisms, specifying the positioning of each mechanism vis-à-vis a single segmentation of the population at national level and common management rules ensuring that the tools proposed are properly coordinated; ensure that it is regularly updated.
- Communicate clearly and centrally on the offer resulting from the various public refinancing mechanisms, for example by setting up a digital information portal.
- Encourage cross-participation between the different mechanisms.
- In the case of sector-based financing mechanisms (particularly for agriculture), their inclusion in a broader financing structure, covering other financial needs (research, technical support, infrastructure) can facilitate the coordinated implementation of financing on the ground.

Recommendations for optimal operational efficiency of mechanisms

Objectives

- Ensure smooth and flexible operational management,

HORUS DEVELOPMENT FINANCE ada

- Minimise the costs of managing the mechanisms.

Resources

- Prioritise the implementation of autonomous mechanisms in their operational management. The proper mobilisation of funds should be governed by clear management rules, professional governance (particularly for approval committees) and regular external audits/evaluations rather than direct involvement of one or more ministerial departments in the approval processes (see more information in 6.1.1, 2 and 3 to ensure this implementation).
- Seek operational efficiency by entrusting funds from different ministerial departments to the same management structure, which does not prevent each ministerial department from dictating its own allocation and reporting rules on the entrusted funds. If ministerial departments choose to provide the structure, they can participate in the governance of the mechanism.