EUROPEAN MICROFINANCE NETWORK

MICROFINANCE CENTRE

EMN-MFC response to the consultation on "non-paper on draft investment guidelines"

30 August 2019

Introductory comments

We welcome the opportunity to give input into the drafting of this document. Stakeholder engagement of this kind ensures that the guidelines are drafted as closely as possible in line with the realities of the market, and it maximises the potential for positive real-world outcomes.

In general we believe these guidelines strike a good balance between setting out the general direction to be followed, while allowing sufficient flexibility to design targeted initiatives where appropriate.

As a general comment, since these guidelines will apply to all kinds of investments (commercial as well as social in nature), we would like to underline the very specific nature of social objective investments and the corresponding social finance.

In order to differentiate in an appropriate way the risk, return and pricing mechanisms and processes, we would stress the difference between **financial** and **economic** factors. The former relates to the private sector investors who rightly expect a commercial cover for their risks and financial return for their financing. The economic "return" is a wider concept that covers externalities (costs and benefits for society as a whole e.g. environmental and social impacts), which do not flow back directly and financially to the investor but rather indirectly to the ones positively or negatively affected by externalities. This fundamental difference must be taken into account whenever risks, returns or pricing are concerned.

In InvestEU, reference is made to the ESF+ definition of microfinance. In ESF+, the microfinance definition states that it "includes guarantees, microcredit, equity and quasi-equity, coupled with […]". However, we note that in itself, "microcredit" here does not have its own definition. It would be helpful to clarify that this could simple be referred to as "credit" (as the features of such credit are well described in the following sentences). We would hope that the current phrasing does not invite implementing partners or other stakeholders to add their own extra definition of microcredit, which would confuse industry efforts.

Comment 1
In section 2.3.1 the document sets out eligible final recipients of finacial support under InvestEU. It sets out that financing and investment operations shall provide support only to financial recipients that are deemed economically viable according to internationally accepted standards at the time of the Union financial support.

- We would welcome some clarification with regards to which standards are being referenced here. Is this merely a check to see whether a company has started insolvency proceedings, or is it more onerous and does it require that the recipients be profitable?
- It is important to note that this requirement may exclude some social finance actors, who may be reliant on public subsidies to continue their operations and fulfill their social objectives based on social rather than financial returns.
- It could be helpful to note explicitly that financial support could be given with the aim of making the recipient more financially sustainable, even if it is not yet the case.

Comment 2

> *On Page 4: For financing and investment operations benefiting final recipients that are large corporates, public sector and public-sector type entities which benefit from easier access to capital markets or display lower levels of risk, the implementing partner shall demonstrate high policy value added.*

We welcome the recognition that financing of large corporates would require higher policy value added. However, this point does not go far enough. When EU budget instruments are dedicated to support a policy objective, the implementing partner should have processes in place that prioritise the achievement of the policy objectives (which includes dedicated support for smaller institutions). If the primary driver for the selection of the beneficiaries is a financial return on investment, then the budget support will follow a private sector investment pattern, with large sums given to large players, which may prejudice the policy objectives of covering market failures.

We would also like to ask if there is an established way to demonstrate the higher policy value added?

Comment 3

> *On Page 5: The EU guarantee shall not be used to pre-finance grants from Union programmes and grants from Union programmes shall not be used to reimburse financing supported by the EU guarantee.*

We would recommend to leave flexibility for this in the exceptional case of duly justified programmes with high policy value added facing market failures under the Social Investment and Skills window.

Comment 4

> *On Page 5: The implementing partner shall contractually require that a financial intermediary cannot include the same operation with final recipients or other intermediaries in more than one portfolio supported by InvestEU.*

Though we understand that this clause is intended to avoid double financing, we would welcome the addition of some extra clarifications that are expressly permitted:

- Financial intermediaries should be able to benefit from microfinance support and social enterprises support instruments simultaneously.

- Financial intermediaries should be able to enjoy the full offer of financial support tools that are available, either concurrently or sequentially, and this shall not be considered double financing.

Comment 5

Under section 2.3.4, we appreciate the application of the General Block Examption Regulations, and consider this to be appropriate given the size and nature of financial support for microcredit.

Comment 6

Under section 2.4. Risk Computation and Pricing Principles, the text explicitly allows implementing partners to rely on standard procedures when pricing return requirements. We have strong concerns here that a purely commercial logic in pricing return requirements will not achieve the social outcome objectives of some instruments, and will also fall short of addressing real market failures. We would recommend aligning this section with the text on page 50, which states explicitly that programme implementation shall not aim at return maximization, and that a target portfolio return as low as 0% may be appropriate. If implementing partners do not have this as part of their standard procedures, this should be addressed more clearly.

Comment 7

> *Under 2.6: In addition, best efforts shall be made to ensure that at the end of the investment period a broad range of eligible sectors listed in Annex II will be covered. This will include in particular nascent or under-developed markets, and will take into account financial products implemented by the implementing partner.*

We support this intention to address a broad range of sectors. We also welcome a focus on underdeveloped markets, and we conside microcredit as a market that is still very far away from meeting potential demand.

Comment 8

Under 2.8: Social sustainability Proofing
Overall we think this is a good starting point, as it is crucial that there is a systematic dialogue about the social impact generated by public-fund-supported initiatives such a microfinance, that goes beyond the financial dimension. Embedding social impact measurement into the DNA of InvestEU's project design is a welcome proposal.

However, from the perspective of structuring responsible investment, we are missing the 'corporate governance' angle, which would be the method that most structurally addresses the overall sustainability of the enterprise.

The document that provides more details on sustainability proofing itself is currently somewhat high level on the details of how this social impact will be measured (which is understandable as it is currently written to cover a wide range of subjects). When it comes to microfinance, EMN would be interested in contributing some more granular metrics than "# of target segment served". EMN is participating in a comprehensive review study of microfinance "social return on investment" measurement methodologies (the "MEMI study", run by universities and microfinanza), and this

study will be completed in Q3 2019. At that point we would be glad to suggest more specific indicators.
Comment 9
Under 2.9: Member State compartments in policy windows We strongly support the existence of this measure, as it allows shared funds to be brought to market in a more efficient way, building on the demonstrated success of EaSI instruments. We also appreciate the flexibility described, where tailor-made financial instruments may be developed if it is more suitable for the market. Microfinance stakeholders have expressed an interest in such instruments in some countries (e.g. Romania, Poland, and Italy), where large internal market deficiencies exist that could benefit from such instruments.
Comment 10
Section 3.4. Social Investment and Skills Window *Actions shall also aim to increase access to and the availability of microfinance and of finance to social enterprises support financing and investment operations related to social investment, competences and skills and develop and consolidate social investment markets, in the areas referred to in point (d) of Article 7(1) and in line with Article 3(2) (d). The window shall facilitate development of skills and key competences, matching, deployment and higher skills utilisation through education, training, including on the job training and related activities.* We would like to express our strong support and appreciation of the clear mention of microfinance here.
Comment 11
Page 41: The window shall in particular target projects that involve a reasonable degree of (prospective) financial viability but that are not delivered or not to a sufficient extent by the market due to higher risks, lack of collateral, not achieving optimal scale without public sector support or other market barriers. Here again the question is raised on what a reasonable degree of prospective financial viability is, as we are aware that some MFIs will be the target of this discussion. Instead, in line with our introductory comments, we would propose to replace "financial viability" with "economic viability", to reflect the more general value that is returned to the wider economy, and not in the form of returned capital to investors.
Comment 12
Page 42: The supported projects shall not crowd out market-based offering of the targeted social services. We understand that this is part of overall EU budget policy and support this principle. However, it is worth explicitly mentioning that the inverse objective is applicable: the projects aim to crowd in private investments to cover unmet needs.
Comment 13

Page 42: Social housing provision should follow a "Housing First" approach and deliver integrated solutions that target the most vulnerable *[proposed addition: as well as different rental and ownership housing schemes for excluded and vulnerable people]*.

Comment 14

On page 43: In addition, financial intermediaries active in the microfinance space shall ensure the provision, directly or indirectly, of non-financial services such as […]

We would recommend leaving some flexibility in the way this is drafted, for instance by adding "shall aim to":

- Not all microfinance institutions can afford to offer comprehensive non-financial services.
- Many microfinance institutions outsource the non-financial services (either truly externally, to close partners, or to another legal entity in the same group)
- Requiring that the same entity that receives financial support also is the one providing non-financial services unintentionalkly advantages the larger banks who can afford to guarantee this.

Comment 15

On Page 43: Conditions such as the cost of borrowing (including the lending rate) and collateral requirements for microfinance directly or indirectly supported in the framework of InvestEU shall reflect the benefit derived by the support and shall be justifiable with regard to underlying risks and the actual cost of funding related to a credit.

We strongly believe that this statement should be further clarified to avoid confusion:

- The cost of borrowing and lending rate, does this refer to the price paid by clients for a microcredit? Or does it refer to the cost of capital that it provided by the implementing partner to the MFI?
- The benefit derived from InvestEU support is very likely to manifest itself in several ways that do not always include influencing the lending rate.
    - Microfinance institutions typically offer the same product to their clients, not differentiating the interest rate based on the source of funding, which would introduce an undue market distortion.
    - Enhanced non-financial services or other operational improvements can be a valid way that InvestEU can support microfinance institutions.
    - InvestEU support may cause microfinance institutions to serve markets that they would otherwise not be able to reach. In bridging this market gap, InvestEU will have achieved its policy objective.
    - There is a need to identify precisely where the market failure stands since, in the microfinance sector, it is more often on the level of the MFI than of the final beneficiary. When it comes to banks, the situation is different since they have more sources of cheap funding (e.g. deposits) which indeed justifies that they pass the benefit of InvestEU down to the beneficiaries (although again creating market distortion).
- We appreciate that even in the case of high interest rates, these may be justifiable with regard to the economic realities of the microfinance institution. We would strongly urge to add, beyond risk and cost of funding, to also mention "operational costs" and "the provision of nonfinancial services" as elements to be considered in the justification. When judging the appropriateness, it should be assessed within peer groups with benchmarks for efficiency, productivity and operational costs.

• It would be good somewhere to ensure there is transparency to client on the total cost of borrowing (like in EuCoGC) as this is not automatically required currently for business loans like it is for consumer loans – it would be good that investEu encourages this as a good practice (but not APRs or other relative measues that clients do not understand).
Comment 16
On page 43 we support the description of the policy objectives with relation to microfinance. We also support the continuing use of the Code of Good Conduct to ensure high ethical standards are met. We take this opportunity to remind that currently code 'endorsements' are not evaluated to ensure their supervisory requirements are equivalent to the Code, which intrinsically skews the EU support for microfinance further towards banks. It would be good somewhere to ensure there is transparency to client on the total cost of borrowing (like in EuCoGC) as this is not automatically required currently for business loans like it is for consumer loans – it would be good that investEu encourages this as a good practice (but not APRs or other relative measues that clients do not understand).
Comment 17
On page 43: We support the operational objectives of ESF+, but reiterate that the microcredit industry has rarely received direct support from the previous ESF programme. The examples of good practices of collaboration are regrettably rare. We do, however, support a strong harmonisation of the InvestEU operational definition of microcredit, and specifically endorse the absence of a fixed maximum size for microcredits. This is a strong improvement over the previous 25,000 euro limit, which did not usefully reflect the significant economic differences across Europe.
Comment 18
*On page 43: Likewise, **grouping of smaller projects** shall be encouraged by implementing partners and financial intermediaries, as many projects in the social space are rather small to attract interest from private investors.* We strongly support this idea, and appreciate to see its development. We would like to add, "to attract interest from private investors <u>or to make better use of public money</u>". An example of such a situation is in Romania, where credit unions are grouped into entitites (UTCAR, UNCAR) which would benefit greatly from financial guarantees if the legal provisions allowed for it.
Comment 19
On page 45: we suggest to add the following bullet point under targeted natural persons: • vulnerable, socially excluded or homeless persons who live in severe housing deprivation and who wish to acquire, build or improve their homes;
Comment 20
On page 46: After micro-enterprises, we would suggest to delete the text "in both start-up and development phase", in order to simplify the text and to be on an equal fotting to the social enterprises mentioned. We would also propose to add "groups of smaller projects" as a type of recipient.
Comment 21

On page 46: Such organizations include, among others, SMEs, large corporations, cooperatives, foundations, venture philanthropists, social impact investors, social investment funds, education and training institutions and providers, triple bottom line ventures, local and municipal authorities.

Comment 22

On page 46: Investment and financing operations shall also support projects from private and public sector organizations active in the social investment space or in need of such investment to tackle, for example, social housing, education and job training of those in need.

Comment 23

On page 47: Guarantees will enable the intermediaries to target final recipients […] at improved conditions than they would have without the guarantee, thereby passing on the benefit arising from the EU intervention. The reduction of the risk premium charged to the final recipients may be in particular considered for InvestEU Fund supported operations under this window.

- The benefit derived from InvestEU support is very likely to manifest itself in several ways that do not always include influencing the lending rate.
  - Microfinance institutions typically offer the same product to their clients, not differentiating the interest rate based on the source of funding, which would introduce an undue market distortion.
  - Enhanced non-financial services or other operational improvements can be a valid way that InvestEU can support microfinance institutions.
  - InvestEU support may cause microfinance institutions to serve markets that they would otherwise not be able to reach. In bridging this market gap, InvestEU will have achieved its policy objective.
  - There is a need to identify precisely where the market failure stands since, in the microfinance sector, it is more often on the level of the MFI than of the final beneficiary. When it comes to banks, the situation is different since they have more sources of cheap funding (e.g. deposits) which indeed justifies that they pass the benefit of InvestEU down to the beneficiaries (although again creating market distortion).

Comment 24

Page 47: Social outcome contracting schemes may be supported, including investments in payment-by-result schemes and social impact bonds in specific areas, in which public procuring bodies (or also private bodies) pursue social impacts based on pre-defined social outcomes, if they result in additionality.

Outcomes contracting typically pushes the risk of failure of a project down to the financial intermediary, in our case the social finance institutions who implement activities that would otherwise not be commercially interesting, but for which they intend to use the subsidies.

- In terms of remuneration, care must be taken that enough financial support is given up-front, so that the MFI does not face liquidity issues trying to bridge the gap between setup and payout.
- In terms of contract design, the success depends on the appropriate choice of indicators, and being sensitive to the risks that these present to the MFIs. If the indicators chosen are overly ambitious, if it is difficult to demonstrate correlation/causation, or if there are certain indicators

that cancel all financial support, these could constitute unacceptable risk to the MFIs and will impact the success of the project.

- It can be difficult to attract private investors to such a scheme, if at least the nominal investment is not guaranteed. The higher remuneration in itself is often not attractive enough to investors if the downside risk is not covered.

Comment 25

Page 48: We appreciate the flexibility on the ceilings for the guarantees in duly justified cases. The fact that microfinance furthers several important policy objectives simultaneously justifies such high guarantees.

Comment 26

> *Page 49: A financial intermediary receiving an EU-backed investment shall commit as part of its investment strategy to invest in eligible recipients an amount equal to at least the higher of: 50% of its invested amounts; and 2 times the amount drawn down under the EU backed investment, capped at 75% of the fund size.*

We would welcome more clarity on this, as its meaning is not clear in the current drafting, and its consequences are likely to be significant.

Comment 27

> *Page 50: The pool of investors willing to invest in the social instruments is currently limited given the return and risk perceptions. In particular, programme implementation shall not aim at return maximization, but rather at a level of return that is sufficient to guarantee alignment of incentives and investor participation. Given that the emphasis shall be on generating a social return rather than a financial return, the target portfolio return for an operation may be as low as 0%.*

We support this clear and positive message.

Comment 28

Page 50: Thematic Financial Producs: We support the scope for targeted projects that address policy goals, as we believe the microfinance sector at European and country level could benefit from such targeted support.
We believe that such targeted projects may be needed to set up platforms that are accessible to smaller microfinance institutions who currently do not have the resources or skills to access EU support, and to set up country-specific instruments that address market failures