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EVALUATION OF
IDB GROUP'S WORK
THROUGH
FINANCIAL INTERMEDIARIES

07

BENCHMARKING OF DEVELOPMENT FINANCE INSTITUTIONS

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ABBREVIATIONS AND ACRONYMS

CABEI	Central American Bank for Economic Integration
BCIE	Banco Centroamericano de Integracion Economica
CAF	Corporación Andina de Fomento (Development Bank of Latin America)
DEG	Deutsche Investitions- und Entwicklungsgesellschaft GmbH (German development finance institution focused on the private sector)
DFI	Development finance institution
EBRD	European Bank for Reconstruction and Development
EIB	European Investment Bank
E&S	Environmental and social
ESMS	Environmental and social management system
FI	Financial intermediary
FMO	Netherlands Development Finance Company
IDB	Inter-American Development Bank
IDBG	Inter-American Development Bank Group
IFC	International Finance Corporation
IO	Investment officer
LAC	Latin America and the Caribbean
MSMEs	Micro, small, and medium-sized enterprises
NBFI	Non-bank financial institution
ODE	Oficina de Evaluación de CABEI
OPIC	Overseas Private Investment Corporation
OVE	Office of Evaluation and Oversight
Proparco	Société de Promotion et de Participation pour la Coopération Économique (French development finance institution focused on the private sector)
SME	Small and medium-sized enterprise
TA	Technical assistance

EXECUTIVE SUMMARY

1. **In 2015, the Office of Evaluation and Oversight (OVE) conducted an evaluation of the financial intermediary (FI) operations of the Inter-American Development Bank Group (IDBG). The evaluation included an examination of other development finance institutions (DFIs) working with FIs in Latin America and the Caribbean (LAC) to better understand the different strategies and operational approaches.** This report summarizes the findings gathered from interviews and desk reviews of the activities of nine DFIs to generate insights on financing trends and best practices, with the aim of informing the future operations of IDBG and other DFIs. Together, these institutions have financed through FIs a cumulative $66 billion in LAC over the last 10 years (2005-2014) and have almost quadrupled their annual investments during the period, increasing their presence and relevance in the region. Working with FIs is considered to be a cost-effective way to reach a large number of relevant beneficiaries. This paper analyzes three main aspects of these DFIs: (i) strategic approach to working with FIs, (ii) internal organization, and (iii) operational approach. While these areas present many similarities across DFIs, there are differences and examples of best practices that provide the opportunity to learn from each other.

2. **Most DFIs' strategic approach is defined in terms of the mix of clients, business segments/products, and financial products, but they often do not have a clear full-fledged strategy.** Instead, different guiding elements are present in several strategic documents. Also, the definition of project goals results in a combination of operational (financial) and development goals. While there are efforts to target activities toward specific areas (green lending, housing, trade finance, agribusiness, women-owned businesses, etc.) the focus to date remains mainly on general financing for small and medium-sized enterprises (SMEs). The selection of client FIs also presents a combination of strategic (e.g., sector focus and regional presence) and operational criteria; the financial soundness and creditworthiness of the selected FIs continues to be a fundamental principle. Yet a trend toward working with FIs in market niches (e.g., non-bank financial institutions, microfinance institutions) is gaining momentum as a way of increasing the impact of the interventions. A more systematic intervention logic—linking inputs and outputs, further focusing on strategic market segments, and increasingly targeting FIs with a relevant area of expertise—would enable DFIs to maximize their development effectiveness.

3. **Regarding internal organization, most DFIs have dedicated FI teams without further division. Incentives are typically skewed toward financial goals, but are starting to incorporate development aspects. The teams' local presence varies across DFIs**. Higher specialization of FI teams by sectors or geographic areas and strong local presence seem to lead to a stronger operational efficiency where the volume of operations allows for such specialization. Clients increasingly value the support of staff with technical expertise as DFIs target some market segments (e.g., green lending). Some institutions are incorporating technical staff within the FI teams or increasing their involvement in the design of the operations. Strong local presence is also perceived as an operational advantage to build rapport with the clients, speed

up responses, and better monitor implementation. Staff performance incentives are increasingly including development parameters, in addition to financial ones, to focus attention on the wider intervention goals, even though the longer time for development goals to materialize presents difficulties.

4. **DFIs define "relevant portfolio" differently, and they structure their operations in various ways, ranging from use of proceeds to portfolio growth.** Given the fungibility of money and bias toward less risky projects, tracking portfolio growth rather than, or in addition to, just identifying the use of proceeds can provide better evidence of achievements and avoid the "funding substitution" effect. Aligning the definition on relevant beneficiaries, mainly SMEs, instead of on the financial intermediaries may also prove more relevant to the market context, help maximize impact, and facilitate monitoring.

5. **While the majority of operations have been in the form of loans in hard currency, several DFIs express an interest in further developing their equity and local currency portfolios.** Equity is perceived as an instrument to increase leverage, foster best practices (e.g., applying environmental and social standards beyond the portfolio financed), and better align with clients' needs. Equity investments involve higher risk, require specific skills, and are relatively scarce and capital-intensive, all of which means that they must be used strategically and purposefully. Local currency lending has also been scarce, as it is difficult to hedge the currency risk where capital markets are not sufficiently developed. Some DFIs are making efforts to better align with the ultimate beneficiaries' needs and reduce currency mismatches between their funding and their cash-flow streams.

6. **There is a general consensus among DFIs on using market-based pricing to prevent market distortions and avoid subsidizing operations, except in special circumstances.** There is recognition that for certain market segments (e.g., green lending), some form of subsidies may make sense to help advance development goals by addressing market barriers and making products more marketable. Technical assistance is also widely acknowledged as an instrument that can help overcome certain nonfinancial barriers.

I. CONTEXT, SCOPE, AND METHODOLOGY

A. Overall context

1.1 **In 2015, the Office of Evaluation and Oversight (OVE) carried out an evaluation of the financial intermediary (FI) operations of the Inter-American Development Bank Group (IDBG). This evaluation included an examination of other development finance institutions (DFIs) working through FIs in Latin America and the Caribbean (LAC) to identify best practices and lessons.** The evaluation revolved around five main evaluation questions (Table I.1). As the evaluation's Approach Paper noted, the fifth question in particular seeks to extract lessons for future FI operations by drawing from IDBG's own experience and that of relevant external parties. This paper presents the insights gained through the benchmarking exercise, with special emphasis on extracting best practices to inform IDBG's future operations.

Table I.1. Evaluation Questions

1. Objectives	What were the objectives of IDBG's FI operations?
2. Achievement	Have these objectives been achieved?
3. Attribution	To what extent can this be attributed to IDBG?
4. External factors	Have external/country factors also played a role?
5. Lessons	What lessons can be drawn for future FI operations?

B. Methodology

1.2 **The analysis of other DFIs was conducted mainly through a review of public documents and interviews with staff of the operational, strategy, and evaluation departments of the selected DFIs.** The benchmarking included a review of annual reports of each DFI for quantitative and qualitative information on its internal organization and governance, operational structure, and operations, with special attention to the financing activities through FIs in LAC. This information was complemented with a review of websites and with semi-structured interviews with relevant staff of different departments of each of these organizations.[1] OVE gratefully acknowledges their contributions and their willingness to provide information, including in response to follow-up requests to address specific data and information gaps.

[1] A list of the people interviewed and the questionnaire used are provided in Annexes 1 and 2, respectively.

C. Identification of main DFIs operating in the LAC region

1.3 **The benchmarking exercise looked at nine DFIs—**five multilaterals (IFC, EIB, EBRD, CAF, and CABEI) and four bilaterals (DEG, FMO, Proparco, and OPIC)[2] to cover a range of relevant players in the region (see Box I.1). The selection of these institutions was based mainly on the volume of their FI operations in LAC and the potential to extract best practices of relevance for IDBG. Only EBRD, a fellow regional development bank, does not have operations in LAC, but it was chosen for its relevance in private sector financing and green lending.

Box I.1 – Benchmarking of other DFIs with presence in LAC

The following organizations were chosen for the benchmarking exercise:

- **International Finance Corporation** (**IFC**) – The World Bank Group's private sector window.
- **European Investment Bank (EIB**) – The European Union's investment bank owned by, and representing the interests of, the EU Member States. It works closely with other EU institutions to implement EU policy.
- **FMO** – The Dutch development bank.
- **DEG** – The private sector branch of the German development bank.
- **Proparco** – The French private sector DFI, jointly held by the French Development Agency and public and private shareholders
- **Overseas Private Investment Corporation** (**OPIC**) – The U.S. government's development finance institution.
- **Corporacion Andina de Fomento (CAF)** – Development Bank of Latin America.
- **Central American Bank for Economic Integration (CABEI)**, focusing on the development of five founding member countries.
- **European Bank for Reconstruction and Development** (**EBRD**) – No activities in LAC, but relevant private sector operations.

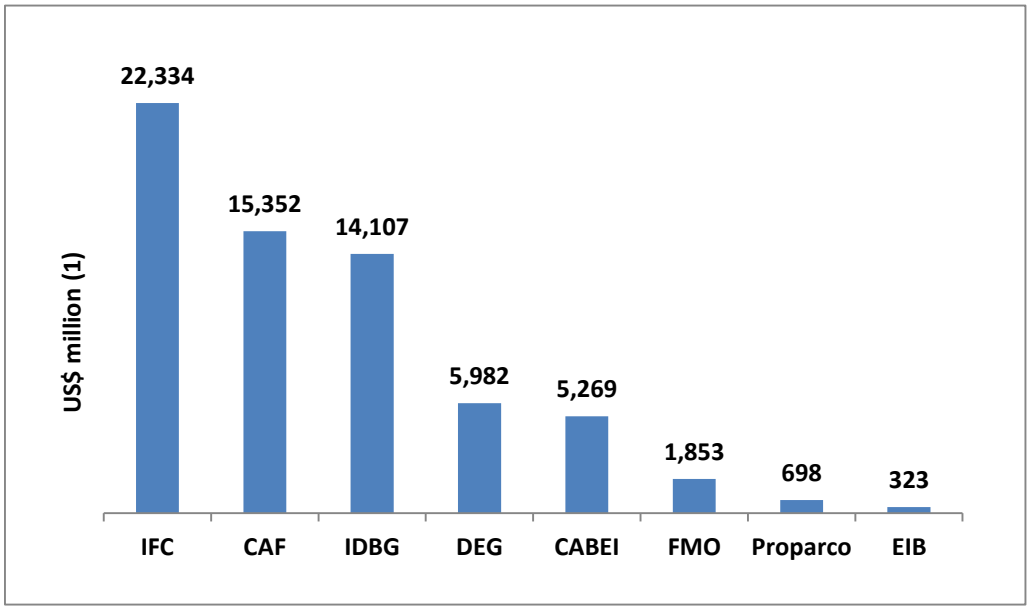
1.4 **This benchmarking focused on non-sovereign-guaranteed (NSG) investments in FIs.** While the operations of IDBG, CAF, and CABEI also include sovereign-guaranteed (SG) loans to public entities (generally second-tier development banks), the focus of this benchmarking was on NSG lending. Thus it did not include the World Bank, which provides only SG lending, but it included IFC, which has only NSG lending. The benchmarked European DFIs focus exclusively on private sector NSG operations.

1.5 **Together with IDBG these DFIs[3] provided $65.9 billion to FIs in LAC between 2005 and 2014.** IFC, CAF, and IDBG were the main investors (Figure I.1), together accounting for almost 80% of the investments.

[2] "OVE will identify a set of comparator DFIs that fund similar FI operations. CAF, IFC, FMO and OPIC are likely comparators from where OVE plans on comparing practices in terms structuring, supervision, internal coordination and external partnerships."

[3] Not including OPIC for which data were not available.

Figure I.1. IFC, CAF, and IDBG were the top three DFIs financing FIs in LAC in 2005-2014



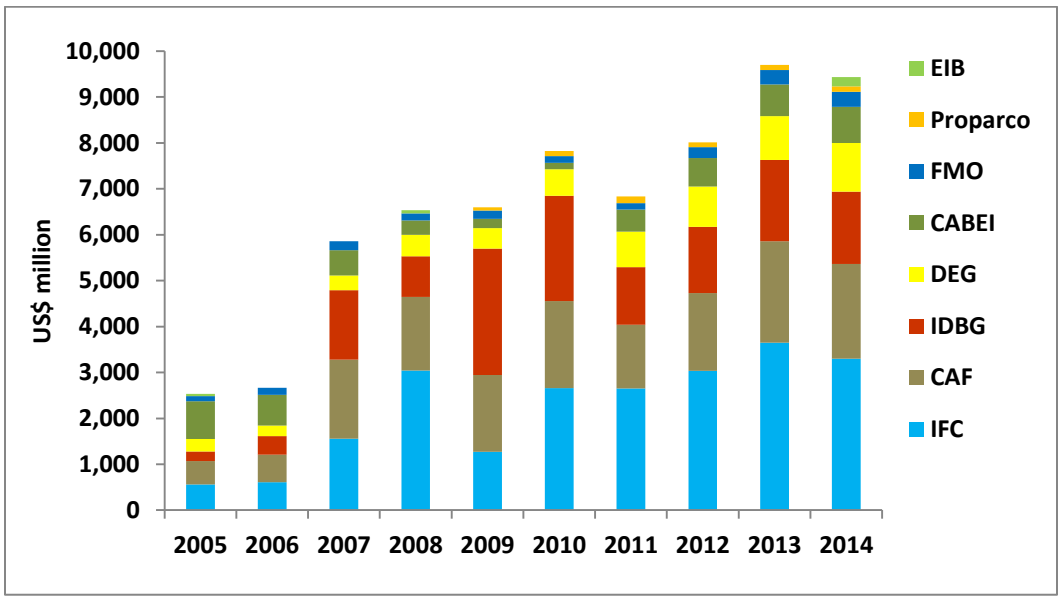
Source: Data provided by DFIs, annual reports, and OVE calculations. Figures represent committed amounts, except for CAF (approved amounts).
Note: For European DFIs, amounts are translated into US$ at annual average exchange rates. IFC includes own amounts and syndicated/mobilized amounts. OVE estimated IFC's trade financing share in LAC as 30% of its total. EIB data include a €150 million credit line in Brazil in 2015.

1.7 **Total annual investment volume almost quadrupled, from $2.5 billion[4] in 2005 to $9.3 billion in 2014** (Figure I.2). The three main DFIs by invested volume—IFC, CAF, and IDBG—all increased their financing during the period, with invested volume peaking during the 2008-2010 crisis. Among the smaller DFIs, DEG and FMO also maintained a trend of sustained growth. Proparco started financing FIs in LAC in 2008 (although it had financed some projects in the Dominican Republic since 1998). CABEI's invested volume decreased during the 2008-10[5] period but recovered by 2014. EIB's operations with FIs in LAC have been more sporadic.

4 Amounts expressed in US dollar equivalent using each year's average $/€ exchange rate for funding from European DFIs.

5 According to CABEI, two factors explain the decrease: first, during the crisis, demand was lower because of the economic contraction; and second, supply was also constrained (although the monetary policy was expansive, the conditions for credit access were restricted as the debt sustainability and fiscal challenges reduced countries' capacity to take debt).

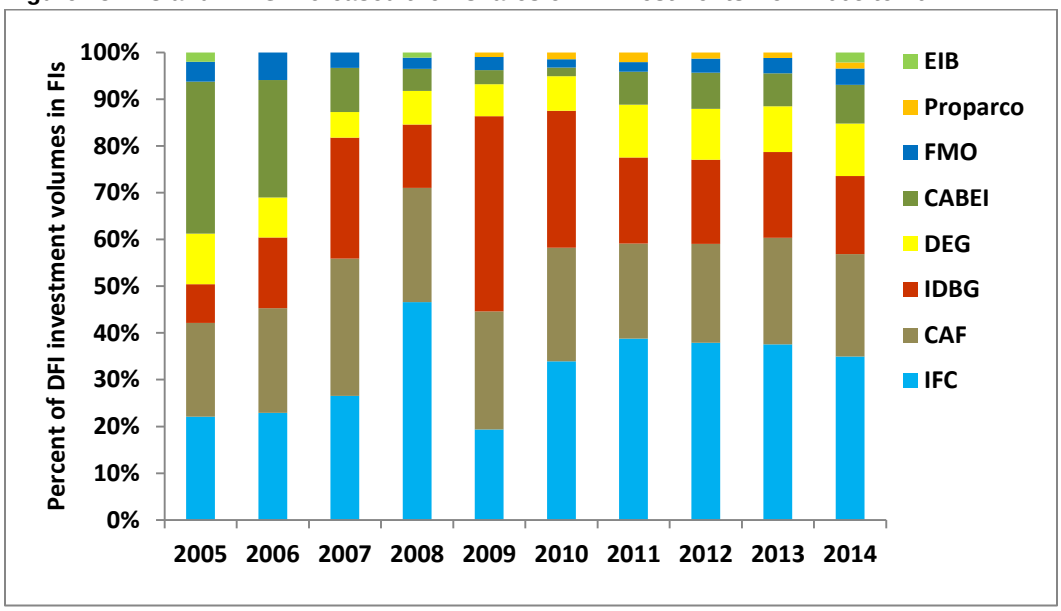
Figure I.2. The DFIs' annual FI investments almost quadrupled between 2005 and 2014



Source: Data provided by DFIs, annual reports and OVE calculations. Figures represent committed amounts, except for CAF (approved amounts).

1.8 **IFC and IDBG increased their relative share of total DFI financing in LAC, whereas CABEI's share decreased as a result of different growth patterns** (Figure I.3). In 2014 IFC and CAF together represented over 50% of total funding. Together with IDBG they amount to almost 80% of total funds. CABEI's loss of share reflects its relatively lower growth rates. CAF maintained a relatively large but stable share throughout the period.

Figure I.3. IFC and IDBG increased their shares of FI investments from 2005 to 2014



Source: Data provided by DFIs, annual reports and OVE calculations. Figures represent committed amounts, except for CAF approved amounts.

1.9 **The remainder of this paper focuses on three main areas: (i) strategic approach, (ii) internal organization, and (iii) operations.** For each of these areas the paper discusses several aspects that have been analyzed across the different DFIs to identify general trends and also to highlight the particular practices of specific institutions. Special attention is given to CAF and IFC as the largest financiers together with IDBG .

II. STRATEGIC APPROACH

A. What are the strategic priorities and goals for FI investments in LAC?

2.1 **Most DFIs' approach for working with FIs is defined in terms of the mix of clients (type of FI), business segments/products (e.g., SMEs and housing) and financial products (e.g., equity, debt).** This approach is captured in different strategy documents rather than in a full-fledged FI strategy paper, partly because working with FIs is not seen as a goal in itself but rather as a means to reach the final beneficiaries. For FI operations the goals are basically the same as for direct operations, but they are targeted through intermediaries. As a result, in several organizations strategic priorities are set in diverse documents (sector strategies, country strategies, environmental and social policies), not always in a coherent way. Some DFIs, such as the World Bank Group or the IDBG, also have strategies defined at the country level, but those strategies do not necessarily reflect goals for the financial sector or FIs. IFC's official strategy guiding document is the "roadmap." In addition, the World Bank Group has country strategies that are based on systematic country diagnostics. For CAF, strengthening financial systems is a critical factor for development, and thus it supports FIs through credit operations, particularly operating countercyclically and focusing on commercial banks and microfinance institutions. National development banks are a specific focus for CAF, and it offers a combination of financing and institutional strengthening.[6]

2.2 **The extent to which these documents guide and inform the design of operations and the allocation of resources varies widely across DFIs.** Not only do many DFIs lack a clear unified strategy, but the strategy drafting does not always involve operational staff. The practical approach to working with FIs often seems to be more demand-driven than strategic. Projects aim to conform with, rather than be shaped by, strategic documents. For example, a DFI may select partner FIs mainly in response to practical parameters, mostly related to credit and operational reach, instead of identifying partners with strategic interests aligned to its own. In some cases, strategic priorities materialize in specific annual business plans. IFC produces (and updates annually) 3-year business plans[7] that target the financing goals through FIs, complementing investment volume incentives. For example, for 2014-2016 IFC's global target was to improve access to finance for 83.6 million microfinance clients and 4.6 million SME clients. Corporate targets are then cascaded down to different departments.

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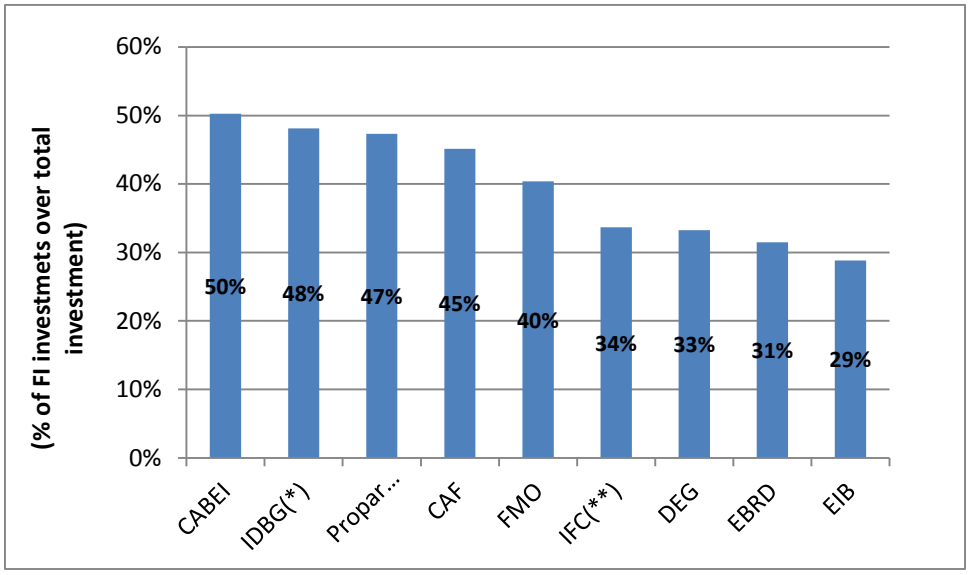
6 Source: CAF 2014 Annual Report and factsheet.

7 Plans also include other components, including expected volume, own account vs. mobilization, country type split, product split etc., as well as targets for IFC's development goals (IDGs).

2.3 **Projects' goals are often set as a combination of financing and development targets.** Financial goals are typically defined by investment volumes (volume of approvals, commitments, or disbursements), and development goals by the number of beneficiaries reached.[8] With regard to invested volumes, DFIs tend to report not on approved amounts, but on committed or disbursed amounts, which more accurately reflect achievements; however, IDBG focuses mainly on approvals.

On average DFIs channel around one third to half of their investment operations through FIs, with varying degrees depending on the institution. FI-operations typically range between 30-50% of the total DFI investment volumes. CABEI, IDBG and Proparco channel close to 50% of their operations through FIs. IFC, DEG, EBRD, EIB are at the lower end with around 30%. In the case of IFC the calculation excludes their trade finance operations as IFC does not consider it appropriate to add trade finance to other investment volumes.[9]

Figure II.1. The use of FIs to channel investment activities varies per DFI



(*) IDBG includes only NSG operations; if SG operations were included, the FI share would be 13%. (**) IFC excludes trade finance.

Best practices and lesson learned

2.4 **A systematic intervention logic/results framework linking the projects' inputs and activities to the desired financial and development goals could provide better guidance for the design of operations and the efficient**

[8] DFIs track the number of beneficiaries with their own methodologies: Development Outcome Tracking System (DOTS) in IFC, Geschäftspolitisches Projektrating/Corporate Policy Project Rating (GPR) in DEG, Transition Impact Monitoring System (TIMS) in EBRD, and so on.

[9] From 2015, for trade finance IFC no longer reports on annual committed volumes but instead on outstanding invested volume at year-end, because the short term nature of the product, makes it inappropriate to add it to longer-term financing products. If trade finance was included, the share of FI financing would be 61%. For comparative purposes, if IDBG did not include trade finance, its share of financing through FIs would be 29%.

allocation of resources. For example, "lack of knowledge" market barriers may be best addressed when technical assistance (TA) is provided along with, or even instead of, financial resources; and policy dialogue may be most useful in addressing deficiencies in the regulatory framework. A recent study by EBRD's evaluation department[10] recommended a program-wide intervention logic for defining Sustainable Energy Finance Facilities, which Management welcomed. EBRD is working to develop a more structured intervention logic to establish a link between projects' inputs and outputs, especially when projects include a bundle of several inputs (e.g., financing, TA, subsidies).

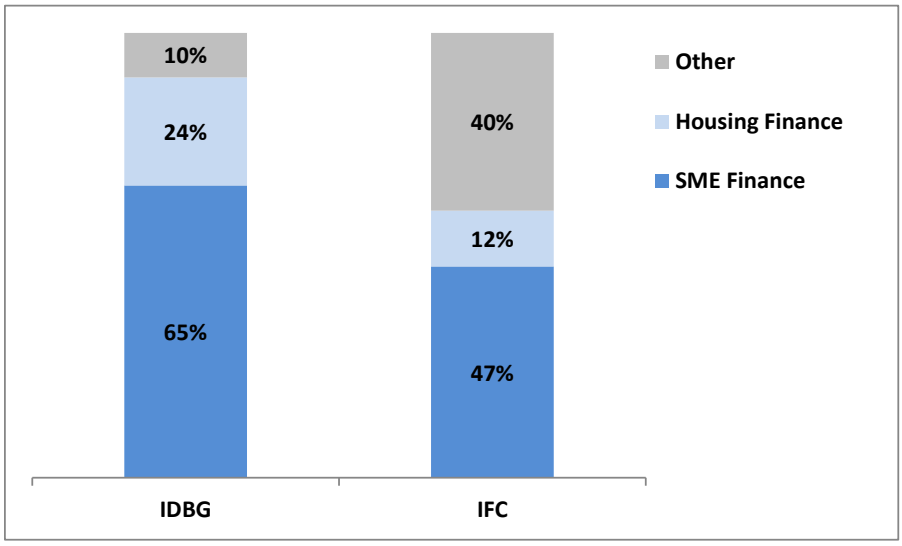
B. What is the FIs' predominant sector focus?

2.5 **Although DFIs provide mainly SME lending, several are increasingly focusing on more specific segments.** SMEs, housing finance, green lending, leasing/factoring, trade finance, and agribusiness are some of the most common products/sectors targeted by DFIs. For example, EIB has a specific product for supporting SMEs through loans (the "Loan for SMEs"). Several DFIs are evolving to focus on specific valued-added niches segmented by size, ownership, or sector. Small SMEs, women-owned/-led SMEs, agri-SMEs, and green lending are receiving special attention. CAF has a significant number of credit operations for FIs, with a particular focus on MSMEs. For NSG operations, commercial banks accounted for over 6% of CAF's 2014 portfolio, and microfinance was also a focus area. Development banks were an important part of CAF's sectoral focus (accounting for 4.4% of CAF's portfolio).[11] For IFC, MSMEs are a clear focus area, with specific numeric targets to improve access to finance. IFC also focuses particularly on women-owned MSMEs, housing finance, and green lending. Figure II.1 compares the main products of IFC and IDBG excluding trade finance. As mentioned before trade finance is seen as a different category given its short term nature. The volumes of trade finance were however significant during the period, an accumulated $9.7 billion in the case of IFC and $4.3 billion for IDBG.

10 "The EBRD's Sustainable Energy Finance Facilities," 2004-2013. EBRD's evaluation department.

11 CAF 2014 Annual Report and factsheet.

Figure II.2. SME finance was the main product for IFC and IDBG in 2005-2014



Source: IFC, IDBG, OVE calculations. Committed volumes. Product split not available for other institutions. Excludes trade finance.

2.6 **Green lending (mainly energy efficiency and renewable energy) is increasingly a focus area through which DFIs address climate change challenges.** FMO has increased its focus on green lending operations in response to the worldwide environmental and climate change challenges and is catalyzing funds to maximize its leverage. For IFC, green lending focuses on renewable energy, energy efficiency, and waste treatment. IFC has also developed a tool (Climate Assessment for FIs) to help FIs assess the effects of their financing on reducing greenhouse gas emissions.

Best practices and lesson learned

2.7 **Sector focus should be based on two factors: (i) what the underserved beneficiaries/needs are, and (ii) what the DFI is best positioned to do given the competitive environment.** For instance, CAF is aiming to provide more targeted loans through sectors such as SMEs and agribusiness, while FMO is increasing its focus on green lending and catalyzing investment. EBRD has been very active in green lending since 2004 through its Sustainable Energy Finance Facilities—packages of loans, TA, subsidies, and policy dialogue that have proven successful in tackling market barriers to financing energy efficiency/ renewable energy.

C. How are FI clients selected?

2.8 **The selection of client FIs is a mixed demand-driven and strategic approach**. DFIs choose FIs on the basis of their financial strength and their potential to reach certain market segments in line with their strategic goals. Several DFIs interviewed stressed the importance of working with creditworthy FIs with a solid financial position and business model. Once this prerequisite is met, DFIs look for institutions with the potential to serve relevant beneficiaries or provide products that are strategic to the DFI, given their specialization, presence

in rural areas, and so on. For example, DEG expressed an interest in working with FIs targeting small firms. Proparco works mainly with larger banks, as its presence in LAC is more recent and it has to be selective. CAF, to ensure the additionality of its interventions, aims to reach underserved segments through its financing; thus it is shifting its focus from general loans to targeted loans (*préstamos dirigidos*). For IFC, the selection of partner FIs is "work on the ground" based on strategic directions and objectives, and it varies by country. Products are more targeted (e.g., green lending) in middle-income countries, and more general in smaller/less developed countries.

2.9 **DFIs are increasingly working with non-bank financial institutions (NBFIs)—non-regulated microfinance institutions, factoring companies, and so on—which tend to reach underserved segments.** Some DFIs target microfinance institutions, leasing companies, and rural financial cooperatives with strong local presence and client reach, which can offer a cost-effective way to reach clients not sufficiently served by larger banks. CAF, for example, highlighted the importance of working with NBFIs as long as they reach underserved segments in a sustainable manner. In some cases (CABEI) the process has been gradual: they initially worked only with regulated FIs (i.e., banks) and from 2001-2002 began to include non-regulated entities, microfinance institutions, credit cooperatives, and so on.

Best practices and lessons learned

2.10 **Prioritizing FI creditworthiness as a criterion is key to the success of the projects, but risks missing opportunities**. There are trade-offs: while this approach is "safer," it might not allow for strengthening weaker FIs or influencing their business model. Working with smaller FIs involves higher risks, and providing loan products may not sufficiently compensate DFIs for those risks. By providing a significant share of funds as equity, IFC can play a strong role in strengthening clients' capacity and business standards, fostering their growth, and – if successful – reaping the benefits in the form of strong returns. When working with large, financially sound banks, there is a case for promoting more sophisticated/focused products to reach niche market segments.

2.11 **The selection criteria can be different across countries, depending on their level of income and financial development.** For instance, working in middle-income countries, FMO seeks institutions in niche segments or with a specific development angle; in lower-income countries it prefers to work with larger solid institutions as the provision of funding to SMEs presents sufficient additionality. There is also a potential benefit in using external consultants to identify areas in special need of funding and potential growth. FMO uses external consultants for preliminary market studies in the early stages of its relationship with FIs.

III. INTERNAL ORGANIZATION

A. How are the DFIs' teams internally organized?

3.1 **Most DFIs have teams specialized in FIs with no further division in terms of sector, geography, and so on.** In most DFIs, FI operations are handled by dedicated departments within the financial market unit, often with support from other technical departments (legal, environmental, energy efficiency, etc.) but usually no further specialization in terms of product or geographical expertise. DEG is an exception: realizing that FI clients value sector knowledge, it now organizes its investment officers (IOs) by subsectors. FMO's FI department has teams divided by region, one of which is LAC. Product experts in every team provide approval/advice in their field of expertise. CABEI also presents some degree of internal organization given that it has established a specialized department (Finance for Majorities) at its headquarters to administrate the programs for FIs, and with regard to the function of different IOs, distinguishing between an identification team, whose mandate is to help generate demand, and an execution and implementation team. IFC has a sufficient scale of operations to have subject experts on many different topics—housing finance, green lending, etc.—who can also draw on IFC's global experience.

Best practices and lessons learned

3.2 **With sector specialization, teams can add value to the client FIs by sharing sector knowledge and offering tailored solutions.** Different sectors or products require different skills and financing. If an institution has a critical mass of staff, internal organization allows it to enhance the value offer by tailoring projects to clients' specific sectoral needs—for example, agri-loans accommodating to agricultural seasonal needs and cash flow stream synchronized with harvest periods; green loans reflecting the long-period cash flow generation of some energy efficiency or renewable energy investments; and housing loans taking into account the legal context and different schemes of ownership. Beyond the financial advantages, sector expertise helps build trust and long-term relationships with clients.

B. To what extent do DFIs have a strong local presence?

3.3 **DFIs' presence in the field varies significantly, depending on the institution's size and its LAC focus.** Smaller DFIs tend to have limited staff on the ground, covering the region from the largest capitals. For example, DEG has only nine people working with FIs in LAC, and their LAC operations are part of their Africa/Latin America division. Understandably, their local presence is limited; they are in Lima and São Paulo, but this does not imply a focus only on these countries. Larger DFIs (and DFIs based in the region) have a more extensive presence on the ground. For instance, the vast majority of IFC staff working on FI investments in LAC are based in the region. DFIs also collaborate among themselves: those that do not have a strong footprint tend to partner more with other DFIs to tackle larger operations and share portfolio risk. They also tend to work with larger and less risky FIs. Proparco prefers to work with FIs that

have previous experience working with DFIs. CAF, CABEI, IFC, and IDBG[12] have a strong footprint in the region. It is important to note that CAF is also a shareholder of national development banks (e.g., in Bolivia and Ecuador).

Best practices and lessons learned

3.4 **Having a local presence represents a competitive operational advantage and allows for building closer relationships with client FIs.** Although for some DFIs, their operations in LAC are too small to justify a permanent office, all acknowledge the convenience of a local presence: it helps identify clients and build a closer long-term relationship, provides a better understanding of the local context, and facilitates implementation and monitoring. DFIs might consider establishing a bigger footprint in a large country to increase coverage, business volume, and operational efficiency. IFC has hub offices in about half of the countries, typically in larger ones (covering about 85% of LAC's population).[13]

C. What are DFIs' performance incentives?

3.5 **Although staff performance incentives are generally skewed toward financial goals, most DFIs are increasingly striving to reward IOs on the basis of development goals.** When development goals are taken into account for the appraisal/assessment of IOs' performance, they are more often based on projects' development potential than on actual achievements verified through the monitoring of development targets. But some DFIs, such as IFC, are making efforts to emphasize development goals as part of the IOs' performance indicators. In IFC's incentive system, staff may receive increases over market reference pay on the basis of their long-term performance achievements. Scorecards cascade incentives from corporate to departmental and individual levels and include development impact, client satisfaction, and financial performance targets.[14] IFC also has "development goals" (e.g., improving access to finance for MSMEs), which are part of the performance objectives of directors and complement annual investment volume objectives.

Best practices and lessons learned

3.6 **Comprehensive organizational incentives can help balance the achievement of both financial and development goals.** There is benefit in aligning incentives for IOs with development goals. Development goals are usually more difficult to quantify and attribute to a DFI's activities. An adequate development monitoring system—based on a pre-defined intervention logic, with objective benchmarks, baseline data, and measurement parameters—can provide a rigorous base on which to assess and reward development achievements. This process requires resources both up front—at the pre-identification of development goals and intervention logic stage—and later, at the monitoring and assessment stages. Since development impact typically materializes only over a longer period of time than that measured by operational and financial goals, it is useful to complement annual performance goals with long-term performance goals that consider development results.

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12 However, IDBG's footprint on the NSG side and specifically with respect to financial sector expertise is more limited.

13 The FI group has a more limited set of hubs – offices with significant presence include Bogotá, São Paulo, Mexico City, Panama City, Lima, and Buenos Aires.

14 For more details, see the COMPAS reports (available at www.mfdr.org/compas), in particular the report for 2008, and IFC Development Goals, available at www.ifc.org/results.

IV. OPERATIONS

A. How do DFIs structure FI operations to focus on development objectives?

4.1 **DFIs structure their operations in various ways, ranging from strictly targeting the use of proceeds to including portfolio growth as an event for default.**[15] IDBG, EIB, and FMO depend mainly on the use of proceeds in their approach—that is, they obtain a list of projects that fulfill certain eligibility criteria. Additionally, EIB requires contractually that financing conditions (e.g., amount, tenor, a certain margin) be passed on to final beneficiaries. Loan contracts between the FI and the SME have to mention that EIB is the source of funds. DEG, Proparco, and CABEI apply both use of proceeds and relevant portfolio growth. In IFC, use of proceeds tends to be used more in specific programs such as green lending; otherwise, relevant portfolio growth is the general focus.

4.2 **The definition of the relevant portfolio, particularly SMEs, differs across DFIs.** IFC uses a loan size proxy for FI operations ($1 million for medium-sized enterprises, and up to $2 million in some advanced countries), and has tested the definition against other criteria (e.g., employees, sales, assets).[16] FMO and OPIC also use IFC's definition. EIB uses the EU definition. Proparco does not have a single definition, but often applies the SME definition used by the local bank, which tends to be smaller than the EU and IFC definitions. The FI's own definition is likely the most relevant for the market context and is the only one with which a strategic alignment between the FIs and DFI can be achieved.

Best practices and lessons learned

4.3 **Focusing on portfolio growth rather than a self-selected list of projects helps the DFI ensure achieving the development goals by minimizing the effects of fungibility of funds.** The DFIs interviewed recognized that funding is fungible and the use-of-proceeds approach can result in cherry-picking—that is, the FI selects from its portfolio the most suitable projects for funding with the DFI's resources. In some cases, selection may be biased toward less risky SMEs/projects. An EIB evaluation on intermediated SME lending within the EU[17] found that the SMEs it financed would likely have been financed in any event, since they were less risky. By contrast, the portfolio growth approach reduces the risk that the DFI's funds merely substitute for other sources of funds, without significantly affecting the portfolio. Nevertheless, to implement a portfolio growth approach it is also necessary to define the relevant portfolio, establish clear baseline data, and take into account the market context and other funding to establish attribution. IFC is setting targets for individual operations that are focused on portfolio growth, and it also sets corporate goals for such increases.

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15 Some DFIs include portfolio growth as a covenant in the loan agreement that allows them to request the return of their funds if a specified increase in the portfolio is not achieved. While this is in practice difficult to enforce, it provides focus and leverage to the DFI.

16 *IFC's SME Loan Size Proxy: A Reliable Predictor of Underlying Small and Medium Enterprises in the IFC's Financial Markets Portfolio*.

17 Ex post evaluation of EIB Intermediated lending to SMEs in the EU, 2005-2011. EIB, October 2013.

4.4 **The FI definition is the most relevant to the market context and enables a strategic alignment between the FI and the DFI.** FIs' more direct market knowledge allows them to establish the relevant definition of what an SME is in terms of volume, assets, employment, or other parameters. In many cases FIs also follow the country's own SME definition. Using their own definition, FIs can also more easily track data—e.g., the size and performance of relevant portfolios—which facilitates reporting and portfolio tracking. Additionally, these are the only data that drive FIs' own strategic decision-making—for example, whether to grow a certain portfolio.

B. What instruments do DFIs mostly use?

4.5 **DFIs offer a wide range of financial instruments, although loans clearly dominate.** Loans are the most used financial instrument, representing 50-90% of total invested amounts, depending on the institution and year. For FMO, for example, loans represented 88% of the total funds provided during the period considered, with decreasing weight in the last few years as equity has gained some momentum (22% of funding in 2014). In Proparco, loans represented 92% of funding for FIs in LAC in 2014. Equity investments were most significant for IFC; over the period they represented around 12% of total funds provided (almost a third when excluding guarantees). Some DFIs are increasing their equity and quasi-equity portfolios (e.g., "portage equity" in the EBRD) in an effort to strengthen their relationship with client FIs and be better able to influence their clients. Equity and subordinated debt are scarce resources in most DFIs (e.g., CAF cannot invest more than 10% of its own equity in equity and sub-debt combined) that need to be used strategically. .

4.6 **To date most funding has been in hard currency, even though local FIs value local currency highly.** DFIs follow different strategies to be able to provide local currency, including funding themselves in local currency to minimize asset-liability currency mismatches and hedging. Hedging is done mainly using local capital markets or hedging-purpose funds such as The Currency Exchange Fund; however, it can be expensive and is limited to markets that have developed capital markets. For instance, DEG has provided guarantees for local currency lending in Mexico when there was a market for hedging future exchange rate risks, but this represents a low percentage of DEG's operations in LAC. FMO indicated that lending in local currency would often be the best option for the client, and it uses Massif fund[18] (a Dutch Government fund), to invest in local currency without hedging. For transactions that are not part of Massif, FMO often proposes local currency to its clients, always including the hedging cost in the pricing—one of the reasons many clients prefer hard currencies, with lower costs. Proparco has done some local currency lending in Peru and Mexico, but most of its operations are also in hard currency to avoid taking unhedged exposure. IFC has developed local currency financing in many markets, often acting as the first issuer to help deepen local capital markets, and then using part of the proceeds to fund investments.[19]

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18 Massif had a total committed portfolio of €325 million as of December 2013, and from 2008 to 2012 the average share of local currency debt in the Massif portfolio's total debt was 71%.

19 For example, IFC has issued local currency products in Brazil, Mexico, Colombia, and more recently Costa Rica. See www.ifc.org/treasury.

4.7 **Several DFIs provide TA as part of their financial operations, mainly to strengthen the FIs and their risk management capabilities.** TA is present in the projects of most DFIs.[20] It is mostly directed to the client FIs, not to the final beneficiaries, and is typically used to build capacity and to support the implementation of environmental and social (E&S) requirements. More exceptionally, some DFIs (e.g., EBRD) may provide TA to the ultimate beneficiaries, usually in relation to more selective products (e.g., in green lending to overcome clients' lack of technical knowledge or make the products more marketable). IFC provides TA ("advisory services" in IFC's terminology) to support the implementation of green lending lines as well as in many other areas—SME banking, microfinance, and so on. A 2008 evaluation[21] by IEG found TA ("advisory services") to be one of six main drivers of the success of MSME financing by covering start-up, training, and the acquisition costs of management systems. CAF uses TA to support the review and improvement of the financial system's regulatory frameworks in shareholder countries to design and incorporate best practices that facilitate users' access to the services offered by the system. Additionally, through reimbursable and non-reimbursable technical cooperation resources, CAF supports initiatives such as projects and platforms for financial inclusion through the use of technology; the generation of knowledge products such as reports, studies, and sector reports; the organization of events and seminars in support of the private sector; and the institutional strengthening of entities.[22]

Best practices and lessons learned

4.8 **Equity or subordinated debt investments can have higher impact on FIs' business, including raising environmental, social, and governance standards.** Several DFIs (IFC, CAF, and FMO) expressed an interest in further developing their equity portfolios to foster best practices and attain development goals, and to achieve higher growth and better alignment with clients' needs. However, equity investments present limitations. Equity can be scarce in some institutions and requires specific investment skills. While equity presents the potential of higher returns for the institutions, that potential also brings higher risk. Certain forms of mezzanine financing or quasi-equity can serve such objectives with lesser risks. For example, EBRD's "portage equity" vehicle allows for an equity representation in the client, providing long-term committed capital and protection while limiting returns through caps and floors and securing an exit strategy that is satisfactory for all parties. IFC has the most significant equity portfolio in LAC, both in total volume and in percentage of its operations, almost one-third if trade financing guarantees are excluded.

4.9 **Local currency lending can better meet the ultimate beneficiaries' needs, but well-developed capital markets are required for DFIs to hedge risks.** Local currency financing helps FIs minimize currency mismatches when financing housing or SMEs (which often operate locally, thus generating cash

20 OPIC is an exception: it does not provide TA directly, but it coordinates with other US government agencies that do, such as USAID and USDA.

21 "Financing micro, small and medium enterprises" – IEG, 2008.

22 CAF 2014 Annual Report and factsheet.

flows in local currency). However, to avoid currency risk, developed capital markets are required for hedging. Alternatively, some DFIs help to develop local capital markets by issuing local currency bonds that are partially used to finance projects (e.g., IFC and EBRD), or take limited currency exposure without hedging (e.g., IDBG, but the total amount is small).

4.10 **Some DFIs are rethinking how to fund TA, including by sharing the cost of the services with the beneficiaries.** DFIs perceive TA as an important tool to promote development goals. However, funding it is a challenge. For many institutions, the capacity to provide TA is based on funding from donors. Fee-for-service and packages bundling TA with lending or equity investments are options to consider. In fact, some DFIs (e.g., IFC), are increasingly operating on a cost-recovery basis, charging clients a service fee. One challenge is to make clients aware of the value of the advisory services, and another is that clients may not be willing to pay for services that constitute a public good. Providing support for product standardization may also help reduce costs and free up resources for complementary non-lending support. Additionally, TA for the final beneficiaries, although less common, has the potential to unlock access to finance. IFC has structured its client facing advisory services to be integrated in the financial institutions group and to have fewer, more standardized business lines—for example, climate, SME, micro, banking strategy and risk management.

C. What are the DFIs' pricing strategy and the role of incentives?

4.11 **DFIs strongly support lending on market terms to avoid market distortions.** All DFIs highlight the importance of pricing on commercial terms and claim that the pricing of their operations is based on a client risk assessment, the internal cost of funding, and/or benchmarking of other DFIs and commercial banks. They often involve several departments to verify market pricing and react accordingly. FMO, for example, seeks the help of its syndications department to verify alignment with market prices. Proparco benchmarks against the market and information provided by the clients, but its pricing is also internally based on other transactions, preferably in the same country.

4.12 **However, some DFIs use incentives in specific cases (green lending) as well as TA to influence and strengthen FIs.** Even with a market-oriented approach, some circumstances and externalities (market barriers) can justify the use of incentives. IFC stressed the importance of operating on a market basis, but in special cases it accompanies the operations with some form of incentives, financed with donor contributions. FMO and Proparco may condition financial incentives on the FI's implementation of a satisfactory ESMS. One rationale is that effective implementation of the ESMS reduces the risk for the DFI, and this should be reflected in the pricing. EIB can provide rebate interest rates outside the EU to advance development goals. EBRD uses incentive payments (rebates) both to FIs and to the final beneficiaries for specific products like energy efficiency and renewable energy to encourage demand by the beneficiaries and compensate for the FI's higher processing costs.

Best practices and lessons learned

4.13 **While pricing based on market terms should be the norm, incentives can help advance development goals, such as portfolio growth or ESMS implementation.** DFIs generally prefer pricing on market terms to avoid creating market distortions. However, there is a case for some form of subsidies (e.g., incentive payments, concessional loans, margin reductions, free TA) when market failures are identified and to promote certain development goals or E&S achievements. Some DFIs (e.g., FMO and Proparco) may reduce margins when certain E&S milestones are achieved.

D. What is the scope of E&S requirements (by type of FI investment)?

4.14 The scope of E&S requirements for FIs varies by DFI. They may be applied to (i) use of proceeds, (ii) asset class, or (iii) the entire FI. The European bilaterals (DEG, FMO, and Proparco) and EIB apply them to the entire FI. CABEI also follows a whole FI approach, with additional requirements in the case of specific riskier projects. OPIC applies their E&S requirements only to the OPIC's use of proceeds but reviews the Environmental and Social Management System (ESMS) of the entire FI, which is a requirement of the IFC Performance Standards. IFC's requirements and the scope of their application for FI clients depend on IFC's investment type, the use of proceeds from the IFC investment, and the level of risk associated with the FI's portfolio. In cases where IFC's investment is targeted to a specified end use (e.g., credit lines for microfinance), IFC's E&S requirements will cover the specified end use only. However, if the FI supports similar activities from its own account, then IFC's requirements will apply to the entire asset class. In cases where IFC provides equity or financial support of a general purpose, IFC's E&S requirements will apply to the entire portfolio of the FI that is originated from the time IFC became a shareholder or investor.

Best practices and lessons learned

4.15 **By applying E&S requirements to the entire FI rather than only to the projects financed, DFIs can prevent the selective exclusion of higher-risk projects.** E&S requirements applied to the use of proceeds can encourage cherry-picking of projects, with FIs selecting projects with lower E&S risk to assign to the DFI-funded portfolio. Thus, the application to the whole FI is commonly recognized as best practice. Most DFIs follow this practice, except for IDBG (and sometimes IFC[23]), which apply E&S requirements to use of proceeds or asset class.

E. How are results reported and monitored?

4.16 **DFIs use periodic reporting to monitor operations for financial and operational performance, development impact, and progress in the implementation of E&S requirements.** Financial monitoring is usually based on

[23] IFC's application of E&S requirements depends on IFC's investment type, the use of proceeds and the level of risk associated with the FI's portfolio and covers (a) specific end use only; (b) entire asset class; or (c) entire FI portfolio.

quarterly/semiannual/annual financial reports. Results are aggregated at the financial and operational level for institutional accountability purposes. Some institutions acknowledge the challenge of benchmarking and measuring development indicators (e.g., greenhouse gas emission reduction in green lending, job creation in SME lending), as the focus of supervision often remains on operational and financial parameters rather than development goals.

Best practices and lessons learned

4.17 **Supervision and monitoring need to address development objectives through adequate benchmarks.** Reporting requirements should include not only financial parameters but also meaningful data on development indicators to assess operations' development impact. There is also an opportunity for coordination between DFIs, especially when co-financing projects or working with the same FIs, to harmonize development benchmarks and facilitate reporting from the FIs. Additionally, when reporting on financing targets, it is better to measure investment volume on the basis of disbursed or at least committed amounts rather than approved amounts, combined with subsequently measuring the growth of the relevant portfolio (by volume and number). This offers a better view of the contributions made in a given period and stresses the focus on ensuring that the funding reaches the targeted beneficiaries.

ANNEX I – LIST OF DFI STAFF INTERVIEWED

DEG

- Ms. Gudrun Busch – Director, Financial Institutions
- Ms. Christiane Rudolph – Director, Corporate Development
- Mr. Thomas Kessler – Senior Investment Manager, Financial Institutions

FMO

- Ms. Chantal Korteweg – Financial Institutions, Manager LAC

PROPARCO

- Ms. Sophie Leroy – Banking and capital markets – Head
- Ms. Odile Conchou – Environmental, Social, Impacts and Governance Division – Head
- Ms. Julie Gonnet – Environmental, Social, Impacts and Governance Division – Senior Officer
- Mr. Pascale Scapecchi – Environmental, Social, Impacts and Governance Division - Officer
- Ms. Gonzague Monreal – Banking and capital markets – Senior Investment Officer

EIB

- Mr. Bastiaan de Laat - Evaluation Expert, Team Leader, Operations Evaluation
- Mr. René-Laurent Ballaguy, Evaluation Expert, Team Leader, Operations evaluation
- Ms. Marie Egret, Evaluator, Operations Evaluation
- Ms. Lourdes Castellanos

IFC

- Mr. Dan Goldblum – Senior Strategy Officer
- Wendy J. Teleki – Head of SME Finance, Financial Institutions Group
- Daniel Sousa – Senior Investment Officer
- Oxana Ware – Strategy Officer

CAF

- Mr. Francisco Olivares – Ejecutivo Principal / Sectores Productivo y Financiero
- Mr. Manuel Malaret – Director Corporativo / Sectores Productivo y Financiero

CABEI

- Mr. Jose Efraín Deras – Jefe Oficina de Evaluación, ODE
- Mr. Sergio Aviles – Coordinador de Finanzas para las Mayorías FINAM
- Mr. Pablo Flores – Analista de Evaluación

OPIC

- Ms. Lori Leonard – MD Economic Impact Analysis Group (Office of Investment Policy)
- Mr. Richard Greenberg – MD MSME Finance, SME Finance
- Ms. Mary Boomgard – MD Environmental Impact Analysis Group (Office of Investment Policy)
- Mr. Todd Allen – Acting MD, Monitoring and Reporting Group (Office of Investment Policy)

EBRD

- Mr. Trevor Watson – FI portfolio manager

ANNEX II – INTERVIEWS QUESTIONNAIRE

Guide for interviews with DFIs

Goals of the interview

- Discuss the strategy and business model of financing the private sector through Financial Intermediaries (FIs) in the region
- Analyze the operational approaches to private sector financing through FIs and distill lessons learned

Questions to guide the conversation

Strategy

1. What are the strategic priorities and goals for FI investments in LAC? How have these priorities changed overtime?
2. To what extent does the strategy implementation respond to market trends?
3. What are the challenges to balance the financial and development goals at the strategy level?
4. How do you select and approach your clients (FIs)?
5. How do you decide on sectors (SME, housing, green lending, leasing & factoring, etc.) for FI-operations in each country?

Organization

6. From an organizational point of view, how is your team internally structured? (e.g., by geography, by financial instruments, by goal, etc.)?
7. What percent of investment officers (IOs) are in the field offices? How autonomous are the field offices relative to HQ?
8. Can you comment on the incentives for IOs and managers, e.g. promotion etc.?
9. What are the performance indicators on which you base compensation of staff?

Operations

10. How do you structure FI operations to ensure achievement of the development goals pursued by your organization?
11. What are the tradeoffs of the different ways of structuring (e.g., list of subprojects versus portfolio growth required, level of specificity of the operation goals, etc.)?
12. What is your perspective on advantages and disadvantages of the different financial instruments that you use? What strategy do you have towards local vs. hard currency lending?
13. What other products or services might help better serve the clients that are not being currently offered (e.g., equity, local currency lending, securitization, etc.)?
14. What is your pricing strategy? What is the role of grants/incentives in your operations?
15. Is technical assistance (TA) used strategically? What gaps are there in the provision of TA?
16. What is the scope of E&S requirements (by types of FI investment)?
17. How are results reported and monitored?
18. What are examples of highly successful and unsuccessful FI operations?
19. In hindsight, what would you do differently with respect to FI operations?


IDB


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Office of
Evaluation
and Oversight