

## **Risk assessment and pricing of financial instruments supporting social purpose organisations such as microfinance institutions (MFIs)<sup>1</sup>**

In the framework of the evaluation of the new Helenos fund for microfinance, the issue of risk assessment and pricing of EU financial instruments popped up. In the case of social purpose investment, we would argue that the risk of loss and the consequent return requirement on an equity investment should be balanced with the social impact. Indeed, of the only two equity investments in MFIs made to date, the case of microStart is an example where the social objective of the project is considered by all parties as fully achieved while, at the same time, the equity investment of the EU budget managed by EIF is financially at loss at the time of exit. The question is thus: how to assess the value of social impact versus financial return and how to factor these into the pricing and performance indicators of the project<sup>2</sup>.

When the EIB Group evaluate an individual project to decide on its eligibility for financial support, contrarily to commercial banks, they conduct an « economic rate of return » (ERR) analysis. This ERR is different from the usual Internal rate of return (IRR) and from the financial rate of return (FRR) in that the ERR takes into account the externalities of the project i.e. all costs and benefits for society as a whole that do not impact the investors in the project themselves. This includes e.g. environmental costs and benefits, employment impact, regional development factors and taxes and subsidies paid or received by the project as well as any other relevant “social impact”.

These externalities are costs and benefits that are not supported/received by the shareholders/investors nor by the clients of the project but by society as a whole. It is thus quite normal that they be covered by public budgets i.e. taxpayer’s money

When working through financial intermediaries to reach micro, small and medium sized enterprises (MSME), obviously, this ERR cannot be calculated on the global operation and it is usually accepted that support to MSMEs is in itself a sufficient economic benefit for society as a whole not to require an individual ERR for each individual sub-project. The alternative is then to define an a-priori list of eligible sectors and to review the objectives, financial strength and modus-operandi of the financial intermediary.

A potential problem starts when the financial institution has social rather than profit objectives. Indeed, the potential consequence is that, before reaching break-even and financial sustainability, it can make individual financial losses in achieving social benefits. This is precisely why it needs to obtain low cost funding, public guarantees and subsidies to ensure a sustainable business model. This global logic however is in contradiction with a pure banking risk-pricing model.

The question thus arises of how to take account of risks AND social returns when pricing an EC/EIB/EIF financial instrument to a social purpose financial intermediary

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<sup>1</sup> Social enterprises in general might be subject to the same approach

<sup>2</sup> The performance indicators of EIF staff might have to be reviewed accordingly.

such as a microfinance institution (MFI)<sup>3</sup>. As a bank, EIB/EIF cannot lower their costs or return requirements because of the social return and they must always keep their risk-return equation balanced. This is where the blending with a grant element from the EU budget comes into play in order to lower the risk to EIB/EIF, be it in the form of a first loss piece, a guarantee or even a full funding. Obviously, for the social impact to be incorporated properly in the pricing/return, the grant element should be provided for free and should be in line with the expected social benefit. It is assumed that State aid rules do not apply in the case of social purpose organisations.

So far so good ! The potential problem would start if EIB/EIF did not lower their price/return requirement in line with the cover provided by the grant element. The questions are thus the following:

- Does an EIB/EIF loan price take account of the guarantee provided by the EU budget to an MFI on its sub-loans to final beneficiaries ?
- Should there be another guarantee product provided directly to EIB/EIF to cover its loans to MFIs ? This instrument would moreover induce a large leverage effect on private sector funding for microfinance.
- In the latter case, is the guarantee priced by the EC<sup>4</sup>, which would lead EIB/EIF to include the price of the guarantee in its final loan price ?
- What is the pricing of an EIB/EIF loan made on mandate and full funding from the EU budget ?
- Does an EIF/EIB equity investment in an MFI based on a first loss piece or even a full funding from EU budget require the same return as a commercial VC operation on own funds or EIB risk capital mandate ?

These questions raise the issue of the internal EIB/EIF/EC process to fix the price and/or return expectation. The EIB/EIF pricing is based on its own cost of funding, its administrative cost and the cover for risk. However, in this model, there is no account taken of the social benefit/impact unless the grant element (equivalent to the social benefit) is fully integrated in the risk assessment and provided for free.

A second level of issues concerns the way to transfer or not the benefit of the free grant component of a financial instrument to the final beneficiary. Here again, one needs to differentiate between intermediaries that have a profit objective vs. those that have a social objective. In the first case, it is pertinent to request that the benefit of the grant element be transferred in one form or another to the final beneficiary in order to avoid adding windfall profit to the intermediary and missing the social objective that is supposed to be reached. However, in the case of a social purpose intermediary, such as a non-bank MFI, the market gap – and thus the social objective – is at the level of the intermediary itself and the policy outcome is expected in terms of sheer volume of credit availability. There is thus no reason to request the transfer of benefit to the final beneficiary or at least to balance the transfer (if any) with the needs of the intermediary. One can see how number of MFIs could simply not operate without the support of the

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<sup>3</sup> It is reminded that the definition of a non-bank MFI includes that it is not « for profit » but for social objective

<sup>4</sup> Is the answer the same for EaSI products and for EFSI products ?

grant element and, for instance, how some cases are already in trouble for the gap in availability of guarantees and funded instruments under EaSI.

In the Helenos examples given in introduction, one could ask (1) that the expected return on the (first loss) equity investment made by EIF on the EaSI budget should be very low and possibly close to zero and (2) that the performance indicator for this investment be defined in social impact terms rather than in profit and loss terms. If EIB was investing additional resources in the fund (e.g. from EFSI), its return requirement should take into account the double guarantee provided by the EaSI first loss piece and the EFSI built-in guarantee (if for free).