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Foundations of Growth

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Investing in financial institutions in frontier markets: Approaches and lessons from DFI activity

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Foundations of Growth

Foundations of Growth is a series of publications that shares the trends, lessons, challenges, and opportunities of investing in frontier markets in Africa. It is aimed at helping development finance institutions develop their strategies for operating in these markets.

You can find other reports in the series at **ariainvests.org**

Introduction

The financial sector is underdeveloped in frontier markets. Small enterprises and a large share of the population lack access to credit and financial services, and even when they are available, bank loans are typically short-term and concentrated in the services and trading sectors. Financial sector development and the expansion of financial services to SMEs and underserved populations can deliver a major impact in these countries. However, frontier markets are significantly more difficult to finance than mainstream emerging markets.

Frontier markets are, by their very nature, deemed high risk, and development finance institutions (DFIs) have a difficult job of balancing their development impact with their responsibilities to preserve value for taxpayers. This paper highlights opportunities and relevant approaches for DFIs to contribute to the development and strengthening of the financial sector to unleash economic growth.

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Definitions of frontier markets

While there is no one single definition of frontier markets, the Africa Resilience Investment Accelerator (ARIA) defines frontier markets as low-income countries underserved by investment capital that are often small and/or fragile. Within this broad definition, there are key common features of these markets including:

i. fragile governments, or recent or ongoing civil or international conflict;

ii. a poor record of robust public policy development and implementation;

iii. poorly governed and weak public institutions;

iv. macro-economic instability and low levels of economic development; and

v. high levels of extreme poverty and low levels of access to finance.

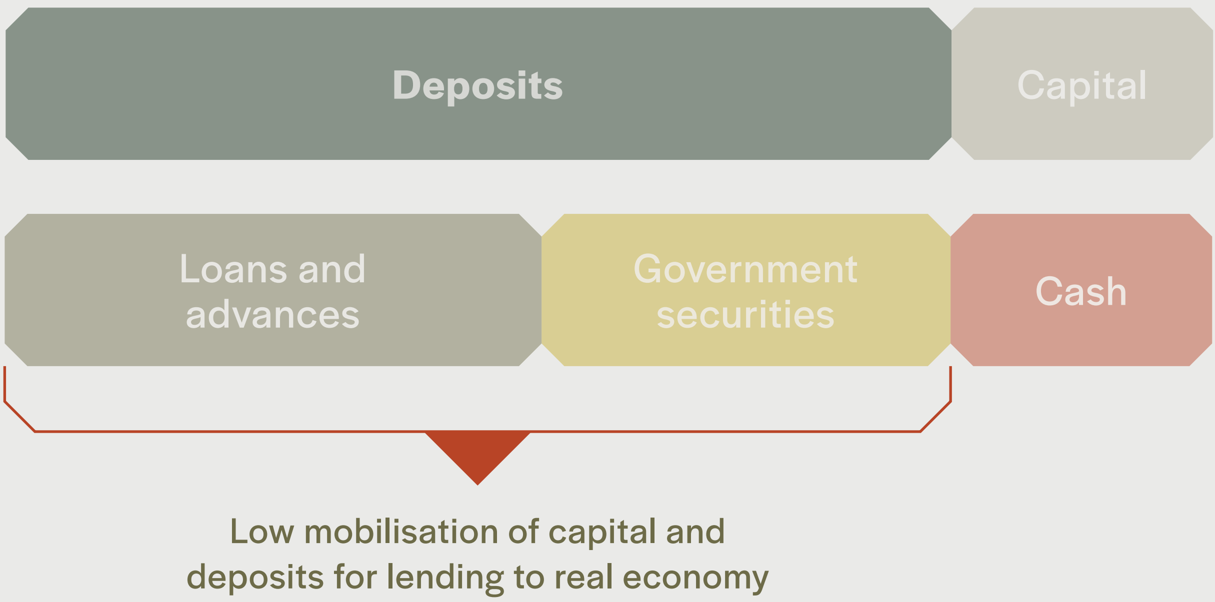
Most of the world's extreme poor live in frontier markets and these countries typically receive limited investments from international financial institutions (although this pattern is evolving with changing global trends in development finance - this topic is discussed in the first two publications in the Foundations of Growth series). Therefore, it is critical that financial institutions in these markets become productive engines of capital formation and economic growth. Consequently, building sustainable financial market systems and increasing access to finance are clear priorities from a development perspective.

Characteristics of the financial sector in frontier markets

Low levels of financial intermediation by credit institutions

It is a feature of some frontier markets that banks and financial institutions tend to allocate assets to relatively safer and high yielding treasury bills rather than to productive investments. This market failure stems from a combination of badly prepared borrowers, missing credit underwriting skills and technologies (particularly in the SME segment of the portfolio), and structural problems financing the government deficit. There is an opportunity for DFIs to work with commercial banks to develop tools that can overcome this barrier.

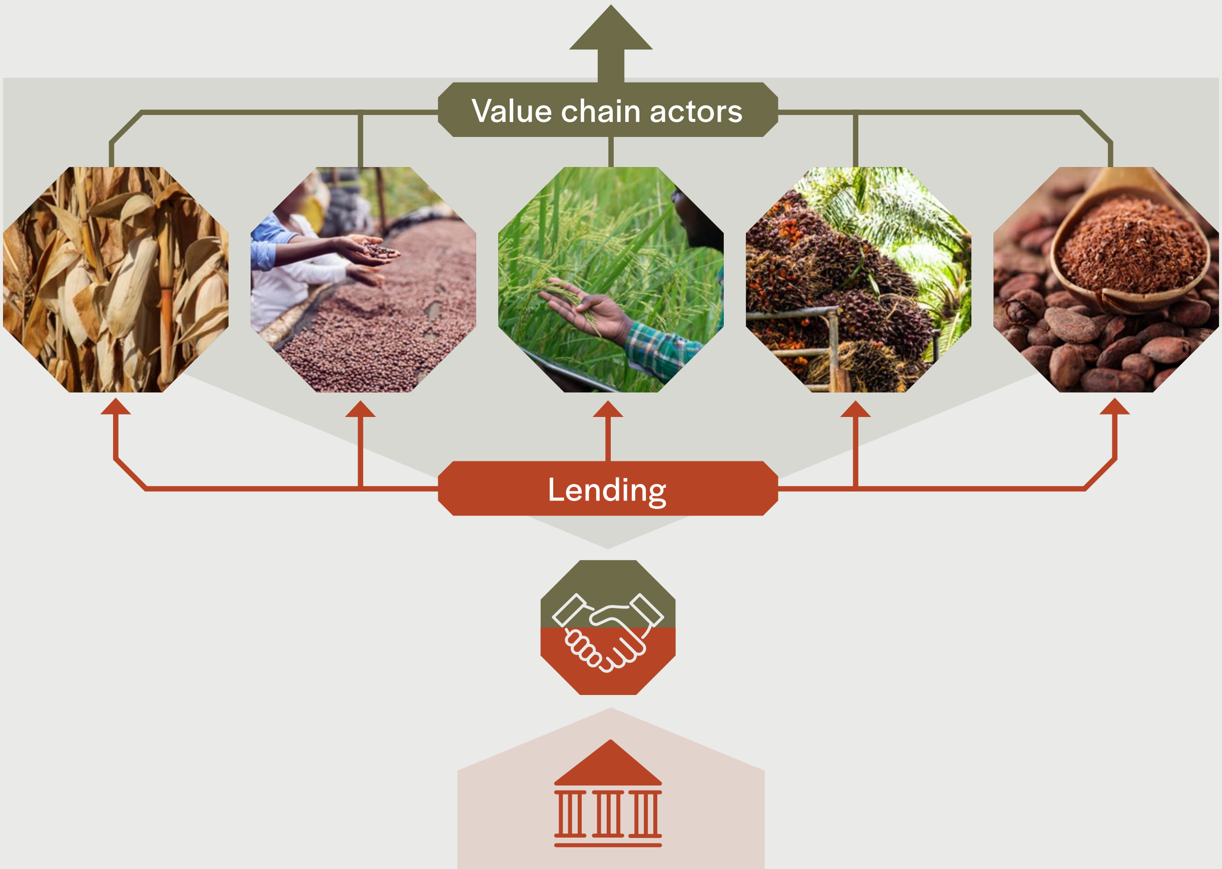
Figure 1 | Hypothetical balance sheet of bank with low loan to deposit ratio



Limited activity and experience in SME and agricultural finance

Across many frontier markets, loans to the agricultural sector account for a small portion of the loan portfolio of local banks, while at the macro-level, the economies of these markets are highly exposed to risks in the sector. Losses due to pestilence and extreme weather are an endemic element of the sector. Market risks occur as commodity prices fluctuate. Some financial institutions are developing their expertise, particularly when it comes to addressing riskier value chains in the agricultural sector. It is in this intersection between the agricultural sector and the SME segment that finance can play a catalysing role in joining smallholders to corporate agribusiness through a value chain approach. This gap is to be expected and is a familiar issue to any bankers with experience in emerging markets. It is also an addressable problem with examples of successful technical assistance interventions overcoming these barriers.

Banks are building knowledge and relationships that improve their risk management for such crops as rice, maize, coffee, cocoa, and palm oil. Lending is integrated into value chain actors, including input supply, farm production, aggregation, processing, and distribution.



Frontier markets demand local currency solutions

Borrowers in frontier markets need financing in local currency. Banks have fewer customers generating export receipts that can support hard currency borrowing. At the same time, the DFI community has difficulties lending in local currencies for a variety of reasons, and when they try in earnest, there is a risk that their terms are not competitive with those offered by local banks. Although some local banks in frontier markets may find hard currency funding from DFIs attractive due to lower interest rates, this renders their balance sheets vulnerable to bouts of depreciation. The DFI community must continue to explore avenues to effectively assume local currency risks or scale-up hedging options, while recognising there are no cheap or simple solutions.

Investment readiness of financial institutions within frontier markets is low

Domestically owned financial institutions sometimes lack capacity to respond to DFIs' requirements around risk management. Sometimes these deficiencies prevent the institution from responding to basic data enquiries required to advance negotiations with DFIs or other investors. Even well-rated top-tier financial institutions can lack capacity in delivering on the development impact objectives conditional to an investment or loan by DFIs.

Lessons learned from past DFI activity

Overly prescriptive qualification criteria and onerous compliance inhibit customer origination

Reaching SMEs directly is often an impossible goal for DFIs. Instead, they apply an intermediated approach through local banks, called 'directed lending'. However, it can be easy to develop an overly prescriptive set of criteria that end-borrowers in frontier markets must meet to qualify for funding. The urge to meet demanding development impact targets can lead to overlaying these criteria with ever stricter financial inclusion or sustainability criteria further diminishing the pool of eligible sub-borrowers. While it is important to reach underbanked segments and address development priorities such as climate, youth, and gender, in frontier markets it can be argued that most injections of capital into the real economy are a positive outcome in and of itself. Particularly if this extension of credit is expanding the pool of bankable borrowers and the risk appetite of lenders. This initial step is needed to eventually achieve the extension of credit to underserved groups.

Naturally, any credit process must comply with minimum due diligence standards, and lines from DFIs usually have an additional overhead required to screen qualifying customers and enhanced ESG risk criteria. This is understandable and necessary given the impact aims of DFIs, but when adding additional diligence and screening requirements for these credit lines it is important to balance these worthy impact targets with the general need in frontier markets for access to finance. This balance is especially challenging in frontier markets where financial institutions may have low levels of capacity or lack the human resources to engage in the complex compliance checks attached to a transaction.

Loosening credit standards will increase defaults

While it is worthwhile exploring different approaches to assessing the financial soundness of financial institution partners in frontier markets, this should not be at the cost of credit quality. Most SME lending in these markets is heavily collateralised, so there is much opportunity to explore traditional balance sheet finance before embarking on unsecured cash-flow lending. Adopting an effective credit rating model helps underpin credit quality where more onerous and subjective financial analysis can obfuscate the finances of borrowers and/or simply slow the process down.

Equity investment can contribute to improved corporate governance

While exiting equity investments in financial institutions can be challenging, one of the benefits of DFI equity investment in local banks is a potential improvement in governance. Through participation on a bank's Board, DFIs can push for better corporate governance, suggest ways to improve operations based on learnings gleaned from other companies, and help widen the pool of prospective customers. Some banking groups in West Africa, for instance, have been able to prudently grow across the region with equity capital support from DFIs, improving access to finance and the general depth of regional capital markets. To be sure, governance challenges do persist, with a common issue in frontier markets being concentrated ownership by family-owned financial-industrial groups, where it is often difficult for smaller shareholders to influence strategy and development impact.

The current capital structure of financial institutions in frontier markets tends to be small and this can limit their capacity to raise financing to on lend to businesses. There is an opportunity for DFIs to help address this challenge by promoting equity investment and creating an environment that supports consolidation of the sector with sizeable institutions that can attract additional investment.

Credit without technical assistance will often underperform

The challenges faced by financial institutions in frontier markets are significant. Not only are they presented with obstacles in terms of the economic and business environment, but most have internal capacity challenges that they need help in tackling. Banks are typically smaller and often lack the critical mass of professionals, especially in head office roles, which will give them the bandwidth to develop their business and operating models. Consultants play a key role in addressing this capacity gap. It is important to note that financial institutions in frontier markets need high-performing advisors with practical experience as much as any tier-1 bank in London or New York. But critically, these consultants also need an understanding of the local context. Developed markets can be much more forgiving; in frontier markets poor decisions can lead to ruin.

Revolving credit facilities must be assessed and used with care

In frontier markets, most lending is short term (one-year or less). Revolving credit facilities (RCFs) for working capital purposes, especially if unsecured, should be liquidated by clearly identifiable transactions on a regular basis, ideally with a clear understanding and potentially some control over the moveable assets they are financing. RCFs that are continually rolled over run the risk of becoming 'hardcore', or forming a component of long-term debt from the perspective of the borrower. Most experienced lenders in frontier markets are aware of these dangers, however sometimes proposals for such facilities come from well-intentioned development financiers or agencies.

Approaches to investing in the financial sector in frontier markets

Develop products better tailored to the local conditions of frontier markets

DFIs often use tightly defined and legally expressed financial structures and instruments. This approach has paid dividends in more mature emerging markets that have deeper financial systems and the requisite professional services. It is therefore tempting to fall back on the comfort of off-the-shelf products when approaching new and more challenging markets. But frontier markets and the financial sector of individual countries have their own characteristics. To help overcome these barriers, DFIs can tailor products to meet the specific needs and conditions of frontier markets. This topic is covered in more detail in the second publication in the Foundations of Growth series.[1]

Focus on fostering SME lending

Given the nascent nature of frontier market economies, supporting economic development in these markets in practice means supporting SMEs. As mentioned previously, one of the most scalable ways DFIs can do this is through directed lending programmes with financial institutions. However, when creating screening and inclusion criteria for end-borrowers of these credit lines, DFIs must take care not to overly limit the pool of potential borrowers.

In frontier markets (and markets globally) adaptation and resilience to climate change as well as addressing gender inequalities are important screens for investment. With that said, when investing in frontier markets, the development finance community must balance these objectives with the need to enable financial institutions to lend to a growing and more robust private sector.

1 https://www.ariainvests.org/news/foundations-of-growth-2

Develop instruments to reach the agriculture sector

As agriculture will remain the backbone of local economies for many frontier markets for the foreseeable future, DFIs should find ways to reach the sector through local financial institutions. This may require innovative approaches, combining concessional lending, with technical assistance and grants, the support to extension services as well as expanding the range of financial institutions DFIs work with, such as tier-2 banks, community banks and savings and credit cooperative societies (SACCOS).

Combine financing products with technical assistance

According to internal research from the Association of European Development Finance Institutions (EDFI), European DFIs signed a total of €18 million across 110 technical assistance projects in the financial sector in 2021. In frontier markets in particular, technical assistance to partner financial institutions should be considered an essential part of the DFI toolkit. Most financial institutions in frontier markets have quite limited exposure to practical SME financing, and the credit culture sometimes needs to be created from first principles, rather than simply trying to downstream the corporate banking franchise. Technical assistance should also be holistic – covering gaps across strategy, corporate governance, marketing, human resources, and information technology amongst others.

Build partnerships with private sector development programmes

To foster SME lending and provide technical assistance, DFIs should actively look to partner with donors and private sector development (PSD) programmes. Other partnership opportunities include working with national development banks. When identifying potential beneficiaries, support from either development or government sponsored enterprise development services (EDS) or agricultural extension services can be a key differentiator in developing a successful portfolio.
The third and fourth publications in the Foundations of Growth series provide practical recommendations for enhancing collaboration between DFIs and donor-funded PSD programmes.[2,3] This more integrated approach makes sure that all the tools of development are being brought to bear on frontier markets to maximise their impact.

Explore opportunities to support development of sustainable loan portfolios

While DFI investments in financial institutions in frontier markets should largely focus on fostering access to finance for SMEs, in some cases, there may be opportunities to design lending products targeting consumer or micro-enterprise borrowers with defined sustainability objectives. For instance, consumer loans for clean cooking, household solar, and energy efficient home improvement. Or agricultural loans for smallholders to purchase agricultural inputs such as climate and disease resistant crop varieties, irrigation equipment, etc. Any of these products could be packaged as part of a sustainable loan portfolio.

2 The third report in the Foundations of Growth series makes the case for donor-DFI collaboration. You can find it here: https://www.ariainvests.org/news/foundations-of-growth-3

3 The fourth report in the Foundations of Growth explores examples of successful donor-DFI collaboration. You can find it here: https://www.ariainvests.org/news/foundations-of-growth-4

Support top-tier commercial banks as apex lenders

In some cases, investing in second-tier credit institutions in frontier markets may be challenging for DFIs. However, supporting the top-tier banks (or perhaps national DFIs) in developing a mature portfolio of tier-2 and possibly tier-3 banks and microfinance institutions may represent an opportunity. In the first instance, many rural and community credit institutions require some level of short-term liquidity support linked to the dominant agricultural production cycles in their locality. As trust builds, then access to longer-term loans and even support in raising debt or equity might be provided by the top-tier banks. In the process, smaller and regional banks will be inducted into the investment process and the diligence it entails could possibly provide more investable opportunities for DFIs over time.

While not common, some financial institutions in frontier markets have successfully benefitted from multiple DFI facilities. This information may be worth considering when determining potential target partner financial institutions. While it takes considerable time and effort for DFIs to structure a transaction, it takes equal time and effort from partner financial institutions. Partners that have already received finance, especially multiple transactions, are likely to be more prepared for the rigours of a transaction and the practical disbursement and management of credit lines, also obviating some of the additional compliance friction that can accompany lending from DFIs.

Consider expanding use of guarantee schemes with concessional elements

Guarantees remain a useful tool when working with financial institutions where risk appetite is the main issue preventing the extension of finance. Partial portfolio guarantee schemes are increasingly common, and recent years have seen the launch of both public as well as private schemes. It is highly possible that more risk sharing mechanisms will be developed in future, particularly structured mechanisms where each party takes on a tranche with a risk profile that aligns with their strategic aims and risk tolerance levels. As with any financial product, the definition of a suitable segmentation strategy, effective alignment with and support to partner financial institutions, and a sustainable business and operating model are critical success factors. It is worth noting that the fees of a commercial guarantee scheme are usually set to cover the risk element of the loan (as opposed to the liquidity element picked up by the primary lender). It is unlikely that a guarantee scheme on its own will entirely closely the gaps in financial intermediation, however, guarantees from DFIs reduce risk weighted assets ratings and encourage more lending. In relation to apex lending, it is notable that cash-backed guarantees are a popular product with rural and community banks seeking to backstop liquidity where they have regular seasonal demands on deposits.

In focus

Guarantee schemes are slowly expanding in frontier markets. Proparco launched its ARIZ guarantee in 2008, which is a risk sharing tool to support financial institutions that are lending to SMEs. In 2022, EDFI launched its MSME Platform. It is an €80 million guarantee facility to enhance the lending capacity of EDFI members to local financial intermediaries that are lending to MSMEs. This was topped up by the €255 million MSME Platform Plus, created as part of the European Fund for Sustainable Development (EFSD+) which includes a €40 million component aimed at reaching agriculture-focused SMEs.

Meanwhile, the African Guarantee Fund was established in 2011 by DANIDA, AECID and the African Development Bank (AFDB), with a mandate of facilitating access to finance for SMEs to enable them to fully play their role of driving the growth of African economies.

Local currency lending

Funding in hard currency is often risky for financial institutions in frontier markets. Lending in local currency and hedging the risk is a problem of the first order if DFIs wish to address frontier markets in a material way. This is a global challenge and likely requires a global solution to be developed within the DFI community. A response to the challenge requires the co-operation and support of a wide range of international and domestic stakeholders, and a blended solution of financial instruments and risk tools.

Simplify success measurement

Sustainability criteria and monitoring, evaluation and learning (MEL) frameworks can be complex. There are sound reasons for this where finance is intermediated by sophisticated financial institutions in large and complex markets and fungibility obscures impact. However, many frontier markets are so small and lending to the real economy is so limited that overly engineered MEL frameworks run the risk of adding expense and slowing down disbursement. The impact of directed credit in these markets is much more readily apparent - even a small number of good SME loans within a comparatively modest facility in frontier markets could make a huge difference. It is worth considering how the impact measurement frameworks for frontier markets could be simplified to focus attention on working with partner financial institutions in building a robust SME banking franchise.

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Contact

To learn more about ARIA and to explore partnership opportunities, please visit our website at **www.ariainvests.org.**

You can contact the ARIA team at **info@ariainvests.org.**

About ARIA

ARIA supports the long-term growth of frontier markets across Africa. It does this by working closely with DFIs and local businesses to mobilise capital where it is needed. ARIA was launched in 2021 at the G7 summit. The initiative is funded by British International Investment, FMO, the Dutch entrepreneurial development bank, and Proparco.