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Outline

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Blending grants and loans for private sector development: The use of grant elements and the AfDB's experience

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Summary

Grant elements in private sector operations are an integral part of the toolkit used by Development Finance Institutions (DFIs) for supporting private sector development. Going beyond the existing literature on grants vs. loans, this brief delves into the conditions under which grant elements should be used in private sector operations by DFIs. In particular, it seeks to (i) a clarify the use of grant elements in private sector lending, (ii) enumerate a number of criteria that should guide the selection and design of operations in cases where grant elements are involved, and (iii) undertake a short evaluation of selected AfDB projects against the defined criteria. Results suggest that blended grant/loan finance should be subject to careful analysis in order to fully gauge the extent to which grants are needed. Emphasis is put on whether the use of grants can have market-disruptive rather than intended market-fixing effects. In this regard, six criteria are brought out to provide a check list against which the use of grant elements should be tested. Based on these, the selected AfDB projects show consistency, yet their review brings out the need for an even more robust and detailed assessment framework.

Introduction

In past years, a vast array of literature has been dedicated to analysing the trade-offs between grants and loans in development financing[2]. Focusing on financial support extended by development finance institutions (DFIs) to developing countries, the debate was largely shaped by lessons learned from the 1980s debt crisis. The practical output of this debate was the establishment of best practices in lending and grant-awarding that include elements such as debt sustainability analysis for loans, or grant financing rationales for global public goods (or 'bads' such as HIV and climate changes). However this debate and its practical implications for institutions revolved around "public sector"/"sovereign" type financing. Although sovereign financing is still important in today's development finance landscape, direct support to the private sector by DFIs has grown steadily over the past years to take on a major place in the development finance landscape (see figure 1).

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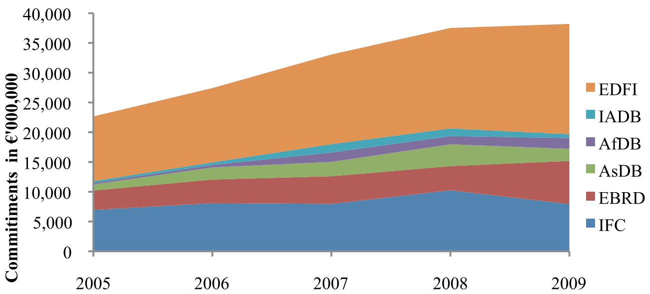
[2] For a comprehensive review and understanding, see Jacquet, Pierre and Jean-Michel Severino (2004), "Prêter, donner: comment aider?", Revue d'économie financière 74, pp. 285-317. See also Jacquet, Pierre (2003), Prêts ou dons, quel financement public du développement?, Complément au rapport no. 43 du Conseil d'Analyse Economique. For a pro-grant perspective see Bulow, Jeremy and Rogoff, Kenneth (2005), Grants versus Loans for Development Banks, American Economic Association Meetings in Philadelphia, Jan 7, 2005.

Figure 1 Commitments of DFIs to the private sector 2005-2009[3]



Source: Compiled by author based on COMPAS 2009, AfDB statistics, EBRD website, IADB and EDFI information to author.

A review of the existing literature on grants vs. loans shows that the debate does not directly cater for private sector development objectives. One of the main reasons is that loans are de facto considered superiors to grants when it comes to private sector development (Jacquet 2003). This brief does not question this premise. Instead, it uses this premise to investigate the conditions under which the use of grant elements in DFI-funded private sector operations (PSOs) should take place.

When it comes to grant financing for the private sector, DFIs usually extend two types of instruments: (i) technical assistance grants, mainly used for capacity building at firm level, and (ii) non-technical assistance grants such as loans with an element of concessionality (e.g. interest rate subsidies, performance based grants, first-loss piece and direct investment grants - see Annex for a detailed typology).

While the former instrument has been the focus of studies and briefs (Proparco 2011, te Velde DW and Warner 2007), the latter has drawn limited interest as its implications have been thought to be relatively straight forward. Indeed, it is widely assumed that "DFIs use principally public funding to reinforce their partner's capacities. They do not generally propose concessional loans or investment grants since they believe that these instruments carry a too high risk of distorting competition"[4] (Proparco 2011: page 4). It is this type of grant element on which this brief is focused.

The brief is organised as follows: the first section defines what is meant by "grant element" and how it can be captured in practice. The second section examines cases in which concessional finance can complement commercial lending using a theoretical approach, i.e. an economic overview of "blending mechanisms". Section three describes the forms and structures of grant elements that best fit DFI objectives using evidence from AfDB lines of credit which benefitted from concessional elements. Section four concludes with some recommendations.

1 | Calculating the grant element of loans and understanding its effects

According to the OECD, the World Bank/IDA and the IMF, a "grant element is defined as the difference between the loan's nominal value (face value) and the sum of the discounted future debt-service payments to be made by the borrower (present value), expressed as a percentage of the loan's face value"[5]. The formula used to calculate the grant element for a loan with equal principal repayments is as following:

$$\text{Grant Element} = \frac{\text{Face Value} - \text{Present Value}}{\text{Face Value}} * 100$$

According to AfDB policies, there is only one case where the private sector department can lend at non-market rates: projects involving a sovereign guarantee. By way of example, borrowing based on commercial interest rate could amount to LIBOR + 450 basis points[6] for an established borrower in a middle income country. A sovereign guarantee to the same borrower would provide a form of "credit enhancement" and de facto allow for a pricing of the loan at LIBOR plus a rate as low as 60 basis points (AfDB 2011). This sort of borrowing implies a concessional funding / subsidy to the extent that there is a grant element embedded in the below market rate pricing of a private entity[7]. Using the formulae above, the grant element embedded in the loan amounts to about 15.5%[8]. Interestingly, this loan would not be considered as fully concessional in the terms of the OECD or the IMF which respectively

[3] Note on the acronyms used in the graph: EDFI is the European Development Finance Institutions, an association of 15 bilateral institutions operating in developing and reforming economies; IADB is the Inter-American Development Bank, AfDB is the African Development Bank, AsDB is the Asian Development Bank, EBRD is the European Bank for Reconstruction and Development and the IFC is the International Financial Corporation.
[4] Original in French. Translated by the author.
[5] http://www.imf.org/external/np/pdr/conc/index.htm
[6] Borrowing costs are usually accounted for as follows: LIBOR + Cost of Funding + Risk Margin. In this example we only use LIBOR and risk margins to emphasise the role of concessional funding. Cost of funding is this assumed to be nil.
[7] For the remainder of the brief, "concessional finance/loan" will be used to express the fact that a grant element is present in what otherwise would be a market-priced loan.
[8] Commercial rate used for this example is the Commercial Interest Reference Rate for the currency of the debt to be incurred by the recipient over the most recently published six month period, as published by the OECD practice (4.44% as of March 2012). LIBOR rates refer to 6 months rates. Note that this is an estimate given that the formula assumes full disbursement and on time, a bi-annual repayment schedule, a 2 years grace period and does not take into account other fees which may be applicable. See http://siteresources.worldbank.org/IDA/Resources/GrantElementCalculator.htm for online calculator.

require a 25% and a 35% grant element to be coined as "concessional"). These thresholds were however designed for public rather than private sector projects[9]. For private sector operations, it remains that a loan with such a grant element would be below market price and potentially result into unfair competition as other commercial lenders would not benefit from this advantage.

This example raises several issues for DFIs. First, most DFIs operate under the understanding that they should be "additional" or bring "value added" to an operation, and as such they do not wish to introduce elements that could disrupt competition nor do they wish to crowd out private sector operators from the markets (COMPAS 2009). In this regard, the 15.5% grant element embedded in the loan constitutes a potential violation of this standard.

Second, extending a grant or subsidy (effectively borne by taxpayers) towards an enterprise that may be profitable can be questionable on the grounds of public spending efficiency and fairness. What is more, in the case in which the enterprise is not profitable, this would also raise questions on the need to subsidise an inefficient project. Economic theory would suggest that these are all undesirable outcomes, yet there are some cases in which justifications can be found: for instance, the public good nature of a project or the fixing of a market failure through the subsidy (Proparco 2011 for a more detailed analysis). They are however subject to many caveats which are elaborated in the following section.

2 | When can grant elements usefully complement commercial loans?

Economic theory suggests that there are situations where grant components may help achieve development impacts that the private sector would not achieve on its own. There are cases where investments are desirable from a societal point of view (i.e. social benefits are higher than social costs), but are too risky or do not yield sufficient financial return to investors. For this reason, they cannot be financed with commercial debt. The underlying reason behind such situation is that there may be market failures, specific barriers to certain socially desirable investments, or from the existence of (negative) externalities at play. For the financing of financial intermediation through lines of credit as undertaken by DFIs, the most commonly found is that of the "first mover externality", linked to the internalisation of regulatory risks, the lack of experience and of track record (see Box 1).

Box 1 The EU SME Facility

As a response to the aftermath of the Russian 1998 financial crisis, the European Commission (EC) put in place a facility to support Small and Medium Size Enterprises (SMEs). The facility's aims were to improve access to finance for SMEs and to establish new business practices within local financial institutions. The EU would provide grant financing to the facility and participating DFIs (EBRD, EIB, CEB and KfW) would provide loans. Financing would then be made available to local financial institutions (LFIs) that would extend it to SMEs. Part of the EC's grant element was to be awarded as a performance fee, i.e. a grant payment to local financial institutions subject to meeting pre-defined financial and institutional criteria. Such fees were in effect off-set against the interest payments made by local financial institutions, and justified as "a necessary subsidy for compensating the trade-off between the financial and social rates of return for this segment".

Rated as moderately successful by EU and EBRD independent evaluations, this model raised several questions: First, on the timing at which such fees should be phased out. In this respect, keeping grant elements for too long would put competing banks at a disadvantage. Too short of a time would not allow the project to fulfil its potential. A solution to this issue would be to monitor the extent to which institutions have built enough capacity and traction in order to be able to on-lend to SMEs without requiring a subsidy – i.e. monitor the extent to which capacity and first mover externalities are still in order. A careful evaluation of improvements in lending practices, portfolio performance and market competition would then be required.

Second, one needs to compose with the "vintage curve" of the SME portfolios. In the short term, participating LFIs would not have trouble accessing the fees by meeting the defined criteria. In the medium term however, any signs of deteriorating portfolio performance would put them at risk of losing the fee by no longer meeting the criteria, thereby exacerbating the uncomfortable position they are going through. Indeed, in some instances throughout the facility's life, the fees were reviewed for these reasons and swapped into technical assistance packages to help address repayment arrear concerns and/or to temporarily relax the qualification criteria. In this sense grant elements should be designed not only to address specific market failures, but also to tackle impediments to projects that are expected to become commercially viable over time.

Source: EBRD 2010a, b

[9] Note that for the IMF, a loan is considered concessional if the grant element is superior to 35%. For the OECD's Development Assistance committee, the threshold stands at 25%. The purposes for these thresholds are however different. The IMF's reasoning lies in budgetary sustainability for borrowing countries and is high due to limits on non-concessional external debt. For the OECD, it is about earmarking development assistance as being eligible as Official Development Assistance and be accounted as such under the national budgets of lending countries/institutions. In the case of private sector lending for development, it can be argued that a threshold is constituted so long as the grant element gives way to a price against which private entities cannot compete.

Complementarity between grants and loans is important when it helps the achievement of socially desired objectives related to failure of the market to ensure equitable income distribution. The most likely case is found in projects involving affordability issues for poorer populations. Using the example of a privately sponsored water distribution project, the cost-recovery imperative of the utility may go against the affordability prerogative of the population. In such a case, the use of investment grants or other subsidy/grant elements can be justified on the grounds of improvements in social development. However, structuring of such subsidies is important. Affordability constraints can also be alleviated by targeted income support for the poor and vulnerable groups rather than investment or blanket operational subsidies. In other words, it is important to ensure that the lower costs of financing derived from the grant element are passed through to the targeted populations in an effective manner. The question of embedding the grant element within the investment as opposed to providing it through another mean to the targeted people should therefore always be born in mind. To ensure the efficiency of the desired subsidy, all alternative scenarios must be considered.

This last consideration brings up the issue of grant element sustainability. Oftentimes, grants can only temporarily alleviate market failures, whereas sustainable solutions may lie in legal and institutional reforms that systematically address market failures through regulatory or market mechanisms. Once market failures and institutional barriers are addressed by regulatory reforms, grant elements can be useful in transition periods to kick-start a change of entrenched behaviours (e.g. such as the inefficient use of energy), stimulate response to a new set of incentives, reward first movers and demonstrate commercial viability of sustainable business models to borrowers and lenders alike (see Box 1). In other words, the use of grant elements should be time-bound with specific indicators related to the achievement of the desired effects. They should not provide adverse incentives to the establishment of alternative fiscal or regulatory support mechanisms which can prove more efficient in the long term. A practical implication for DFIs is that for each project being financed in which a grant element is involved, project appraisal should include an analysis highlighting the missed opportunities for regulation/reform upgrade.

Based on the discussion above and the findings of the EU's paper on the Additionality of grants in the Framework of Blending Mechanisms (2009)[10], the following three principles for the utilisation of blended finance in private sector projects are put forward:

- **Targeting** – the use of grant elements should not crowd-out more sustainable solutions. It should be focused on development objectives that cannot be achieved with regulatory and market-based instruments alone in the short term.
- **Leverage** (financial, policy, behavioural) – grant elements should leverage sustainable private finance and support a process of regulatory reform or behaviour change of beneficiaries.
- **Commercial Viability** – grant elements should not jeopardize commercially viability of projects in the medium to long run (see Box 1).

Other distortions created by grants can include the displacement of investments. In instances where the borrower passes on the full subsidy onto the customer, publicly announced subsidised lending can create "irrational" but overwhelming expectations among the population of potential beneficiaries thereby fuelling speculation: collectively, entrepreneurs know that not all of them can benefit from the grant element, but individually everybody thinks s/he will be the one. Therefore they walk away from market competing financiers and spare their own equity while forming a queue for subsidised loans that are finite and not available to all. In this way, embedding grant elements in lines of credit which pass them on to consumers can encourage situations of moral hazard, accelerating few investments and delaying many others.

Grant elements can crowd out private investors. Knowing that they cannot compete with the subsidised lending from which a bank is benefitting, competitors walk away from the targeted sectors thereby decreasing the total volume of loans to target beneficiaries, contrary to the original intentions of the project. Finally, another negative side effect is that subsidised lenders will face incentives to increase private interest rates to augment their margins, knowing that subsidised loans will anyway be more attractive than financial products of un-subsidised competitors.

To avoid falling into cases where grant elements induce such distortions, three other assessment principles are suggested (European Commission 2009; EBRD 2010b):

- **Market and Policy Alignment** – the grant element should be in line with resource allocation consistent with policy objectives and market dynamics. It should not encourage the

[10] See also EBRD 2010b for the application of these criteria in the context of EBRD projects and "transition impact".

formation of economic waste, rent-seeking, irrational behaviours or negative externalities.

- **Focus** – the grant should be targeted specifically at the underlying problem and beneficiaries, and its form should be tailored to the specific market failure or barrier to be addressed.
- **Efficiency** – the grant should be assessed through financial analysis of rents and cost-benefit analysis in order to ensure that its size is adequately proportionate to its objectives.

3 | From theory to practice: a short review of AfDB's experience

At the early stages of its project cycle, the AfDB engages in an "additionality and development outcomes assessment" (ADOA) of private sector operations. Such an assessment is geared towards answering two fundamental questions that would ensure that the Bank is indeed engaging into the type of operations it should as per its mandate:

(i) Are the Bank's PSOs consistent with its mandate to foster social and economic development and reduce poverty in its regional member countries?
(ii) Is the participation of the Bank necessary, or would the project – with the same outcomes – be funded by commercial operators alone? (AfDB 2008)

The first question pertains to the expected development outcomes, while the latter describes the concept of additionality. For the purpose of this analysis, only Additionality concerns are examined. It is noteworthy to highlight that the while the adequacy of concessional elements in private sector operation is looked at on an ad-hoc basis through the ADOA framework, other institutions such as the IFC had a corporate level committee which approves the use, the structure, and the terms of blended finance.

In 2011, three of the 26 projects submitted to the board and assessed through the ADOA framework were lines of credit backed by a sovereign guarantee. Two of these three projects (LOC 1 and LOC 2)[11] were similar in nature and are thus treated together in the review below: financial institutions on-lending to Small and Medium size Enterprises (SMEs). On-lending rates were capped, effectively meaning that the grant elements would be passed on to consumers. The third project (LOC 3) involved financing of financial institutions that were not exclusively focused on SMEs and did not include on-lending restrictions. At any rate, the sovereign backing of these projects implied a pricing set at below market standards as discussed in section 1.

At first glance the price-differentiation of such projects points to a situation of 'crowding out' as no commercial financier can match the price offered by the AfDB. This would present a lack of financial additionality[12]. Yet all LOCs were credited with a satisfactory Additionality score (positive rating).

In the case of LOCs 1 and 2, the "crowding out" argument of on-lending at below-market rates to an institution is well understood and applied in the ADOA assessment. For both lines of credit, Additionality was assessed as stemming from the provision of long term funding to a financial institution that will support credit constrained medium size firms in financing export expansion and diversification of existing projects. Additionality would also pertain to the institution's inability to access resources in the market on affordable commercial terms. This is due to the subsidized rates it offers to its clients as per government decree.

The first take-away from this justification of financial Additionality is that the client bank would not have been able to raise any funding if it had to borrow at market level. This however begs the question over its viability and sustainability as a banking institution. Other things being equal, a pro-market argument would be that if deemed unviable without lower than market price funding, helping out this institution would distort the market and prove to be unfair competition to other banks' lending in the same segment. Simulations in table 1 show a net margin in the area of 1% to 2% in the no grant element scenario, against a net margin in the range of 5,5% to 6% in the presence of a concessional rate. Considering that this does not take into account the Bank's cost of funding, the commercial viability criterion would barely hold.

This project nevertheless offers a rationale for subsidized on-lending which is nested in an argument of market failure: information asymmetries plaguing the SME lending market for which financing is unavailable. This led the government to cap the institution's on-lending interest rates so that SMEs could receive adequate financing. Given this on-lending cap, the banking institution must find financing that will allow it to cover

[11] For confidentiality reasons, project names have been replaced.
[12] Additionality assessments are done based on 3 criteria: political risks mitigation, financial Additionality and improved development outcomes. The rating for each category (as well as for the overall score) is based on a 4 point scale ranging from none, marginally positive, positive and strongly positive. In particular, financial additionality measures the extent to which there is a crowding in/out effect, contribution to currency matching, maturity matching and resource mobilization, plus any other improvement to commercial viability.

Table 1 Simulations on LOC 1

	With grant	Without grant
A. Weighted average on-lending rate of the institution	13%	13%
B. Weighted average on-lending rate in the country	21%	21%
C. Borrowing rate of the institution (LIBOR + risk margin)	1,5%	6 %
D. Gross Margin: on-lending (A-C)	11,5%	7%
E. Estimated provisions for operating expenses and loan-loss provisions	5-6%	5-6%
F. Net Margin (D-E)	5,5% -6,5%	1% - 2%

Source: AfDB estimates, information from client.

its costs and lend to SMEs as put forward in table 1. African SMEs are underserved due to risk perceptions and as such, the targeting of the subsidy/grant element (both at the level of the AfDB's lending to the client Bank and at the level of the client bank's lending to firms) is an element that attempts to address a defined market failure. This rationale covers the criteria related to alignment and focus. The question of whether this is the most sustainable solution to the SME issue, as per the targeting criterion is also raised in this context: while this set-up provides what can be assessed as costly (in terms of subsidies), it remains a short to medium term solution to be accompanied by other regulatory policies. While the project did not entail any regulatory objectives, the Bank's operations in the targeted country include several "business enabling environment" programmes. This points to having concerted, or "integrated" approaches to sectors where private sector operation financing would go hand in hand with policy-based operations that tackle relevant regulatory aspects.

This case also raises an issue with regards to rent capture: it is very difficult to prevent borrowing institutions from capturing a significant part of the subsidy as lender's rent. In the case of LOC 1 and LOC 2 presented here, there is a legally binding obligation of the client bank to pass the lower price onto consumers, i.e. that the efficiency criterion holds. Yet it is still important to ensure that more than just a small portion of grant element reaches the final beneficiaries and that it leverages the desired behaviour. Along the same vein, it should also be ensured that the low-priced finance does not encourage excessively risky lending, i.e. moral hazard.

Last but not least, in terms of the leverage criterion (that is where grant elements should leverage sustainable private finance and support a process of regulatory reform or behaviour change), the specific projects only meet it in principle. In theory, the LOCs should lead to demonstration effects highlighting that SMEs can be financed successfully and that they do not present risks as high as those perceived thus enticing Banks to enter into the segment. In practice however, there is no evidence ex-ante that such project would lead to the leverage of finance, regulatory reform or behaviour.

In the case of LOC 3, the justification of financial additionality was based on the fact that DFIs were playing a countercyclical role by providing long term financing to support the financial sector in a country that underwent political turmoil. Findings of a recent analysis on the country's banking system highlighted although no systemic crisis occurred as a consequence of political events, the banking sector experienced tensions on liquidity.

This rationale also had a narrow and specific scope in mind: providing liquidity to the financial system for on-lending to SMEs. Yet in contrast to the previous example, the market failure at stake is different as it is limited in time. The perceived and expected targeting and sustainability criteria are the underlying factors that fundamentally differentiate this project from the others: as the situation normalizes, i.e. when there are no longer tensions on liquidity, the rationale for financial additionality would no longer be applicable. In the previous case, the lack of sustainability was a factor of the high prevailing interest rates in the country and liquidity did not play a factor.

To some extent it can be argued that the sustainability part in the first example can be addressed through technical assistance (TA). Indeed, a TA package was crafted with a focus on staff training, better lending methodologies and the set-up of an Environmental and Social Monitoring System. Such capacity building is intended to significantly improve institutional ability to on-lend, and strengthen the delivery of linked development outcomes. The underlying motivation of such TA is that it will help institutions better understand SMEs, better gauge the risks involved and consequently tame part of the information asymmetry problem. Usually such TA is designed as a grant which would meet all of the criteria needed. In this case however, they were made part of the lending and paid for by the clients (which one can argue, de facto reduce the grant element of the non-market based lending).

4 | Conclusions and recommendations

When it comes to understanding the level of concessionality involved in a project, the OECD's, the World Bank's and the IMF's definition can prove useful. However, what is more relevant for private sector operations is the threshold against which a grant element is market-distorting.

Recommendation 1: Based on this, a certain threshold of acceptability could be devised to inform the extent to which a project is benefitting from a subsidy (if not formally, then as a rule of thumb). This could be analysed against the environment in which the project is being financed to make a more informed decision on the level of financial additionality (or lack thereof).

Further to the understanding of what grant elements are and how they can be measured, this brief outlined 6 key criteria that would be used for ensuring that their use does not bring out any negative externality and that their efficiency is maximised.

Recommendation 2: The criteria should be used as guiding principles for DFIs over the course of project appraisal in cases where grant elements are used. The application of these tests should not be a rigid exercise. Country and sector conditions matter and as such should be taken into account. They however offer a checklist of potential red-flags which can influence the economic assessment of projects.

Through a short retrospective of projects at the AfDB against the defined criteria a distinction was made over the effects of grant elements on financial additionality and their effects on private sector development. One important take-away is the crucial need to assess whether the project crowds out other entities. A second take-away is the importance of testing whether the lending re-enforces existing distortions, or whether it actually tackles market failures. Experience has shown that it can do both, and as such the net effect should be assessed. In this spirit, project analysis should go further than simply taking for granted that by supporting a private sector entity, the private sector as a whole is supported. It must be made sure that private operations have a positive net effect in this regard.

Recommendation 3: DFI assessments of projects should take into account the purpose/target of grant elements (i.e. on the social benefits) and be structured in a way that maximizes incentives to improve (environmental, social and other) performance and implementation. Grant elements should not compete with the private financial sector, but instead should be structured so that they reinforce the activities of the private project sponsors and leverage private finance to uncharted territories of targeted projects. In particular, project assessments must be very explicit in determining how they would minimize or avoid distorting markets, displacing private sector investment or reducing market competitiveness.

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6 | Annex 1

"Blended finance" typology from: European Commission (2009), Working Group on the Additionality of grants in the Framework of Blending Mechanisms.

Direct investment grants: they provide direct finance for specific components of a project. They are the straightforward approach for assistance targeted at meeting redistributive objectives (pro-poor pro-growth development) or in cases where a significant cross-border externality of the investment under consideration justifies grant coverage of part of the costs. For projects which can derive positive financial returns and do not target these objectives, standard grants are not appropriate in order not to undermine efforts of e.g. collecting fees.

Conditionality / performance based grants (such as Output Based Aid): they are grants whose disbursement is linked to compliance with ex-ante defined conditions or service level performance targets. Their use becomes more pertinent the higher the donor support and are particularly justified in countries with weak governance where even marginal impacts could bring rewards in the overall business environment and where the use of such instruments can be a mechanism to align interest of the beneficiaries with the overall policy objectives pursued. Certain investment grants to projects can be put within this category which highlights the importance of an underlying policy linked to clear medium to long term objectives for the programme, and the adequate involvement of the beneficiary parties.

Interest rate subsidies: grant elements used to cover part of the interest payments. The partner country or project promoter thus receives a subsidised loan at below market interest rates rather than a separate loan and grant. Interest rate subsidies – like investment grants – are used to enhance the concessionality of a financing package, e.g. to comply with debt sustainability requirements. If transaction costs for obtaining a credit are relatively high, donor support could be used to reduce part of these transaction costs without entering the lending market itself (increase transparency, evaluate collateral, or assist in paperwork). On the other hand, they may present a distortion effect, if access to financial markets or to un-concessional lending from other DFIs is warranted for the project promoter, as they directly reduce private and public sector loans' competitiveness. Furthermore, interest rate subsidies may lead to uncertainty on whether the donor support completely reaches the borrower over the life of the loan (e.g. in case of anticipated or accelerated repayment).

Loan guarantees: they offer the lender recourse in case of default. In underdeveloped markets, capital preservation is a crucial factor for investors. Sharing the risk (losses) via loan guarantees, might entice lenders to open their financing for a specific country/sector/niche of companies. Losses, hence payments, materialise only ex-post, when real defaults occur – which probably means overall a higher gearing ratio (i.e. financial leverage such as debt-to-equity) in most cases. This assumes particular relevance in case of portfolio loan guarantees where added diversification further reduces the cost of risk coverage, thus optimising the budgetary impact. With a guarantee (provided free of charge or at a relatively low price to the lender), the interest rate charged to the borrower will be lower than without; from this perspective the effect of a loan guarantee can be similar to an interest rate subsidy. It may also help to lower collateral requirements. Loan guarantees can be combined with grant support to address particular market failures.

Structured finance - first-loss piece: Donor interventions can play a significant role in structured finance projects. They are essentially needed for investing into the highest risk tranche of the structure (first-loss piece), thereby leveraging additional funding from international and bilateral development banks as well as the private sector. As for risk or mezzanine capital, the implied donor support element needs to be determined with care so as to optimise the participation of other financing partners and to allow for the crowding-in of private sector financing. In this context, it can be advisable to maintain some risk sharing with the project promoter even for the first lost tranche to ensure the required alignment of interest. The assumption should be that a finance institution investing its own money in the first-loss piece should aim at generating a return, while the donor support element should enable such institution to take an additional risk.