

PRIVATE INVESTMENT MOBILIZATION MODELS (PIMMS) FACT SHEET:

Risk Sharing with Financial Intermediaries – Private Sector (PIMM8)

EXECUTIVE SUMMARY

PIMM8 is designed to increase the supply of portfolio loan guarantees to stimulate more lenders to lend in developing countries.

OBJECTIVES

Mobilize financial intermediaries to provide more loans by offering portfolio-level instruments that: (i) reduce the amount of regulatory capital required by the intermediary; and/or (ii) cause the financial intermediary to lend to riskier segments (e.g., micro, small, and medium-sized enterprises (MSMEs)).

Expected to primarily support MSMEs and smallholders but not restricted to those segments.

Rationale	<p>The risk rating of borrowers in developing countries is driven primarily by high-risk sovereign risk ratings (e.g., median B rating and 76% rated B or lower). Applying sovereign ceiling convention – most projects/borrowers would have implied ratings of B, CCC, and CC impeding many banks and monetary financial institutions (MFIs) from lending.</p> <p>The cost of lending to MSMEs and smallholders can be high resulting in low/poor return on capital – the guarantee reduces regulatory capital and improves return on capital to acceptable levels.</p> <p>Many financial intermediaries in developing countries do not have enough capital to expand loan portfolios. The risk guarantee allows those intermediaries to use their limited capital to lend to more companies, for example, a 50-50 portfolio guarantee allows a bank to double its loan portfolio.</p>
Description	<p>Catalytic and concessional (C&C) funding shares the credit risk of a financial institution's portfolio of loans to private sector borrowers. The C&C funding provides a guarantee, partial guarantee, and/or risk-sharing agreement to the financial intermediary to increase the supply of loans from financial intermediaries to borrowers, mobilizing debt investment (e.g., loans) directly.</p> <ul style="list-style-type: none"> • Most common expected applications of PIMM8 are to: (i) provide portfolio-level guarantees to financial intermediaries; (ii) capitalize guarantee-issuing organizations (e.g., African Guarantee Fund (AGF); and (iii) re-guarantee guarantee-issuing organizations (e.g., Sida counter-guarantee of AGF) • The size of loans being catalyzed is generally expected to be less than USD 100,000. PIMM8 is not expected to be deployed for large projects and borrowers (e.g., more than USD 1 million). • PIMM8 is a complement to PIMM3 (Domestic Financial Sector Development).

Development rationale	<p>Financial intermediaries (e.g., commercial banks) often do not lend to viable borrowers and small projects in low and middle-income countries since they: (i) assess the risk to be too high; (ii) the return on capital is too low due to high administration costs especially for very small loans; and/or (iii) the intermediaries do not have sufficient capital to expand their loan portfolio.</p> <ul style="list-style-type: none"> • In most cases, PIMM8 is expected to provide partial guarantees on a portfolio of loans, for example, 50-50 pari passu. In some cases, PIMM8 could provide a first-loss guarantee, for example, to cover the first 5% of losses in a portfolio of smallholder loans. • C&C funding for PIMM8 is critical to mobilize loans to viable, small borrowers/projects assessed by lenders (e.g., banks and MFIs) to be too high risk. It is particularly important to mobilize local currency debt from domestic sources. • Making C&C funding available for guarantees is expected to increase MSME and smallholder loans to fund more capital investment. • Increasing financing to MSMEs and smallholders has many advantages, including catalyzing entrepreneurship, creating jobs, (e.g., the African Development Bank forecasts more than 80% of jobs created in Africa in the next decade will be from small and medium-sized enterprises (SMEs) and financial inclusion. <p>C&C funding to provide guarantees to financial intermediaries to provide more loans also supports the development community's view that the perceived risk of investing in developing countries is higher than actual risk. C&C funding to provide partial guarantees or risk sharing underwrites the delta between perceived and actual risk – if risk (i.e., defaults and losses) unfolds at higher levels consistent with private investors' perceptions then the C&C funding as guarantor capital will be depleted. If defaults and losses unfold closer to the development community's view, then the guarantee/risk sharing mechanism will likely collect premiums at a rate sufficient to cover actual losses, thereby preserving C&C funding.</p>
Existing comparable precedents of C&C funding	<p>African Guarantee Fund (AGF), capitalized by the Government of Denmark, the African Development Bank, the French Development Agency, and the Nordic Development Fund with a Fitch risk rating of AA US Development Finance Corporation's Direct Credit Authority.</p>
Indicative activities for Network of C&C Funders	<p>The Network of C&C Funders could establish a sub-group of organizations interested in awarding funding to support the growth of portfolio-level partial guarantees and risk sharing with financial intermediaries. Several approaches to award their funds to the best proposals/cases aligned to PIMM8:</p> <ol style="list-style-type: none"> 1. <u>Direct call for proposals to financial intermediaries in developing countries (e.g., banks):</u> A call for proposals where domestic banks, MFIs, and other intermediaries are invited to submit a proposal describing how they could benefit from C&C funding, guarantees, and risk sharing to increase their lending to target beneficiaries (e.g., SMEs). The Network members would assess the proposals and award their funding to the best proposals. 2. <u>Call for proposals to multilateral development banks (MDBs), development finance institutions (DFIs), and public development banks:</u> A call for proposals where these development finance institutions are invited to submit proposals describing how they could deploy C&C funding or guarantees to provide: (i) loans directly to MSMEs; or (ii) guarantees to mobilize domestic banks, MFIs and others intermediaries to increase their lending to target beneficiaries (e.g., SMEs). 3. <u>Call for proposals to developing country governments:</u> A call for proposals to developing country governments to submit a proposal describing how they could deploy C&C funding or guarantees to provide guarantees that mobilize domestic banks, MFIs, and other intermediaries to increase their lending to target beneficiaries (e.g., SMEs).

Indicative activities for Network of C&C Funders (cont.)	<p>4. <u>Call for proposals to guarantee issuing organizations</u>: A call for proposals to: (i) existing organizations like AGF; (ii) to establish new organizations like AGF; or (iii) to expand existing financial intermediaries' product offering to issue guarantees.</p> <p>In addition, individual country governments (e.g., the Government of Kenya) could issue comparable call(s) for proposals where they would be the lead C&C funder to stimulate guarantee issuance in Kenya.</p> <p>In competitive global calls for proposals, it is expected the Network could receive hundreds of proposals annually facilitating the awarding of C&C funding on a quasi-auction basis.</p>
Expected C&C funding instrument	The majority of C&C funding is expected to be guarantees and loans for fair/equitable outcomes.
Expected financial profile of C&C funding (including risk profile)	<p>C&C funding deployed in PIMM8 is expected to take on a risk profile beyond the willingness or ability of MDBs and DFIs. There are likely two possible financial expectations of C&C funding in PIMM8:</p> <ul style="list-style-type: none"> • <u>Partial loss expectations</u>: It is likely a portion (potentially a majority) of C&C funding would result in a partial loss. • <u>Break-even or better expectations</u>: It is possible a portion of C&C funding could be deployed at break-even (or better) financial outcomes.
Expected sources of private investment mobilized	<ol style="list-style-type: none"> 1. Direct: Domestic financial intermediaries (e.g., banks, microfinance institutions, and fintech) that make loans to MSMEs, smallholders, and companies. 2. Direct: Organizations like AGF or private investors seeking to establish an organization like AGF. 3. Indirect: Owners of MSMEs and companies that will co-fund projects with their own equity, complemented by new guaranteed loans.
Expected leverage	Reasonable leverage expectations in PIMM8 range from 2-20 times.
A single-country or multi-country application	<p>Both. PIMM8 is expected to be deployed mostly for multiple countries but also for a single country:</p> <ul style="list-style-type: none"> • Guarantors issuing guarantees in multiple countries, like AGF. • Guarantors issuing guarantees in a single country. GuarantCo was originally established to issue guarantees in multiple countries, but over time it identified the benefit of collaborating with domestic institutional investors to focus on one country, initially in Nigeria, and subsequently in Pakistan and Kenya.

Recommended standardization for this PIMM

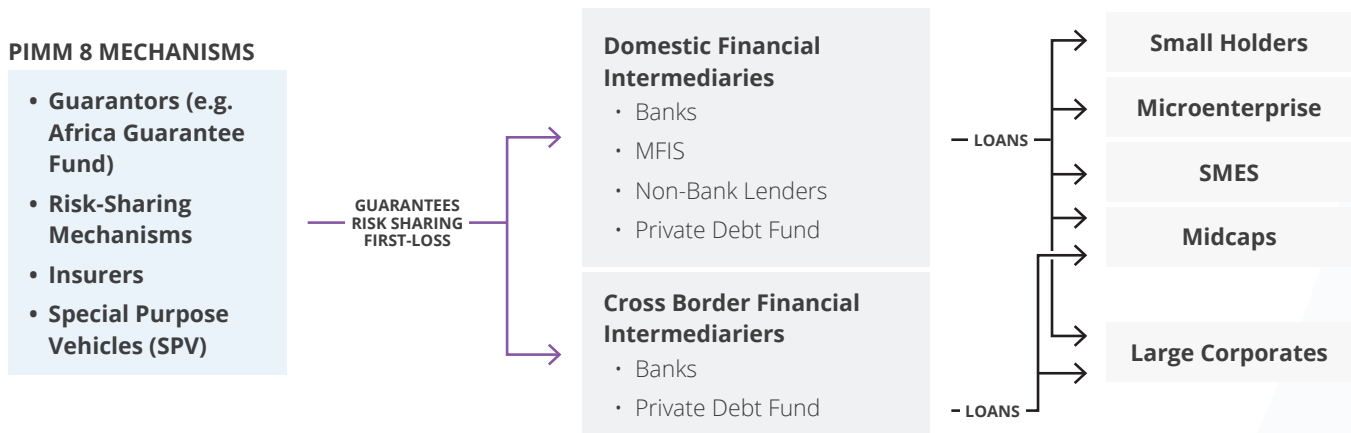
Convergence recommends five types of standardization for C&C funding for PIMM8:

1. Guarantees to banks, microfinance institutions, and other intermediaries to: (i) be on a portfolio basis; and (ii) to guarantee only a portion of the loans (e.g., 50% pari passu and/or 5% first loss).
2. Organizations that issue guarantees in multiple countries (e.g., AGF) should be rated by one of the Big 3 rating agencies as Investment Grade (BBB).
3. Organizations that issue guarantees in a single country should be rated by a leading rating agency in that country, at the equivalent of local A+ or better.
4. C&C funding should be limited to supporting guarantors that will issue guarantees fully complying with the Bank for International Settlements (BIS) Capital Accord guidelines on guarantees qualifying for capital relief, such as irrevocable and unconditional payment obligations.
5. Guarantees issued by Organisation for Economic Co-operation and Development Development Assistance Committee members, MDBs, and DFIs to counter-guarantee private sector guarantee issuers should comply with the BIS Capital Accord guidelines on guarantees qualifying for capital relief, such as irrevocable and unconditional payment obligations.

Over time, the Network might identify the benefits of additional standardization of PIMM8.

RISK-SHARING MECHANISM ADHERING TO PIMM8:

This figure depicts risk-sharing with domestic and cross-border financial intermediaries for illustrative purposes. The intent of PIMM8 is to support risk-sharing with domestic financial intermediaries.



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