EDFI European Development Finance Institutions

Market Benchmarking Guidelines

Development Finance Institutions (DFIs) are mandated to provide *sustainable long-term financing on terms that are, in principle, market-based* in order to "crowd in" rather than "crowd out" private investors while achieving the intended development impacts. This guidance note considers challenges, limitations and potential best practices for DFIs to use to operate in line with this principle by using benchmarks. As such, the note is intended to promote attention to these challenges and the advancement of good practices in DFIs' private sector development finance operations.

I. Introduction

To achieve the Sustainable Development Goals (SDGs), trillions of dollars of investments are needed over time. For Africa, the Business and Sustainable Development Commission estimated in 2017 that the path towards achieving the SDGs will generate US$1.1 trillion worth of business opportunities by 2030.[1] Even as the supply of funding from DFIs and multilateral development banks (MDBs) has increased, these investments will not add up to what is needed to achieve the SDGs. To address the common challenges MDBs and DFIs face in achieving the SDGs, mobilising more private capital from commercial investors is necessary.

Private investors invest in emerging markets if the interest rate compensates appropriately for the risk. To maximise impact and comply with the additionality principle (see note on competition law), it is important that private investors are not "crowded out" of opportunities in which they would be prepared to invest on their own or together with DFIs. Instead, DFIs should aim to "crowd in" private investors where possible, by creating conditions in which the private sector is prepared to invest on commercial terms alongside a DFI or MDB, when they would not have been prepared to do so alone.

To "crowd in" the private sector, and seek to achieve the SDGs, DFIs should: (1) aim to offer market-based prices through benchmarking against commercial market factors; and (2) respect the *Enhanced DFI Principles for Blended Concessional Finance* when offering subsidised funding. This document is the product of the work of a taskforce of expert practitioners from European DFIs in 2020. It sets out best practice guidelines for DFIs to benchmark their individual prices against commercial market factors in cases where concessional funding is not used.

II. Rationale and methodology for market benchmarking

The guidelines included in this document focus on mechanisms for market benchmarking for long-term senior debt. Other products can be priced using similar methods, or by benchmarking such senior debt pricing, but equity valuations, in particular, are often governed by bespoke factors.

Note on competition law: It should be noted that EDFI members are independent competitors to each other as providers of financing, and each EDFI member must therefore make its own strategic and commercial decisions, including pricing decisions, unilaterally. EDFI guidance to members is designed to share best practice and is not intended to impose restrictions on EDFI members' ability to determine their own strategic and commercial behaviour. DFIs are free to adopt their own pricing methodologies according to their own commercial and strategic priorities, and EDFI and its members are fully committed to compliance with competition laws in all relevant jurisdictions.

[1] http://report.businesscommission.org/reports/better-business-better-world-africa

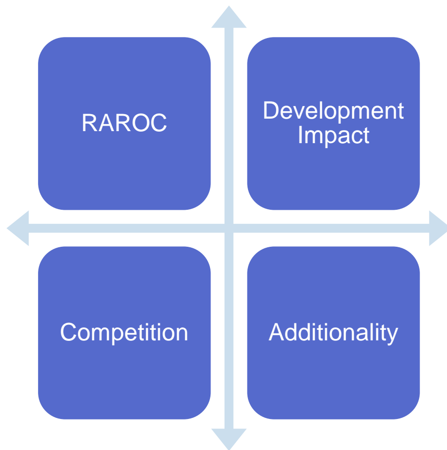

Figure 1: Example of input parameters for pricing by DFIs

DFIs typically use different parameters and perspectives to set a price for the loans they offer. Price setting by a DFI will be the result of a combination of various elements and will differ from institution to institution, based on the DFI's own relevant circumstances and goals. Common factors that DFIs typically take into account in pricing decisions are funding costs, operational costs, return expectations, risk assessments (RAROC = risk adjusted return on capital) of countries and clients, the competition in any given market and the strategic focus of the respective institutions. Supplementing these commonly found features, DFIs will also consider the development impact they are aiming for, as well as additionality considerations (see Figure 1)."Market benchmarking" for the purposes of this document refers to benchmarking as many observable data points[2] in the capital markets for a debt product of a similar type/structure, similar credit profile and similar tenor as possible, each of which will be the result of the considerations described above. The price range distribution arising from the data points can be viewed as a "market-based price".

The requirement for additionality (relative to private capital) results in DFIs often operating in opaque markets where there is limited availability of appropriate benchmarks or pricing data points. Their lending is often a direct function of the necessity to close the gap where capital markets fail or are not sufficiently developed to form a well-established market-based price. To avoid long term market distortions, DFIs should therefore strive to find data points that stem from private debt providers as evidence for an appropriate "market-based price", rather than referencing data points from transactions by other DFIs.

DFIs operate by setting high standards and principles[3] around their operations, to safeguard their mission and vision. "Off-market" pricing will not serve the DFIs' mission in the long term, because it will distort commercial debt markets and may "crowd out" private sector investment. By contrast, market benchmarking will support "crowding in" private sector capital. To meet their long-term objectives and achieve the SDGs, it is therefore recommended that DFIs endeavour to benchmark their pricing to the market (except in cases of blended concessional funding provided according to enhanced principles), where the return requirement meets the risk appetite of private capital.

The final section of this document sets out high level guidance for DFIs engaging in market benchmarking for their individual offerings. As noted above, each DFI must make its own strategic and commercial decisions, including pricing decisions, unilaterally.

[2] Excluding datapoints related to previous DFI and MDB debt.

[3] See for example the *Enhanced DFI Principles for Blended Concessional Finance for DFI Private Sector Operations,* as included in the most recent joint report of the [DFI Working Group on Blended Concessional Finance for Private Sector Projects](#).

III. Existing methodologies used by DFIs.

DFIs that already use benchmarking as part of their pricing methodologies typically apply the following factors in a consistent order:

a) Assessment of the Country Risk, including but not limited to: (A) Sovereign Bonds Spreads; (B) Emerging Market Bond Index (EMBI) spreads; and (C) Sovereign Credit Default Swap (CDS) spreads.

b) Assessment of the corporate bond market, including but not limited to Zero-volatility (Z) spreads of corporate bonds or Asset Swap (ASW) spreads outstanding in the same sector and with characteristics similar to the transaction under consideration.

c) Assessment of the syndicated loan market (using public sources), including but not limited to the margins on recently closed syndicated transactions.

d) Assessment of other publicly available market intelligence regarding developments in the industry and lending activities in general.

e) A resulting 'Pricing Advice' that sets out a recommendation for an appropriate price based on prescribed steps, including (A) the analysis of the above-mentioned benchmarks and market characteristics; and (B) internal discussion about the expected investment appetite of other market players. Producing this price recommendation may be the responsibility of a dedicated unit or knowledge centre.

For internal and Return on Equity (ROE) purposes, DFIs may benchmark their pricing against RAROC models, cost of funds and liquidity requirements, and they may be required to do so under their respective regulatory frameworks.

IV. Challenges of existing methodologies

The existing methodologies used by DFIs suffer from several potential limitations, including:

- *Limited availability of market data points in emerging markets*: For some countries, no EMBI spread or bond information is available. In those cases, the DFI's price recommendation is generally based on market data from comparable countries (geographic region, rating and market), which may decrease the accuracy and appropriateness of the recommendation.
- *Lack of liquidity of debt instruments in emerging markets*: This reduces the price on bonds and thus increases Z-spreads. Furthermore, scarce trading volumes could be a proxy for increased volatility in spreads.
- *High volatility and high number of uncertainties (i.e., risks)*: In the markets in which the DFIs typically operate it is difficult to predict the short- and long-term effects of macroeconomic or political changes. Therefore, changes in the market may not be (or may only partially be) incorporated in pricing recommendations.
- *Difficulty of comparing transactions*: As transactions differ in terms of region, country, tenor, average life, company credit rating, strategic focus, etc., it is difficult for DFIs to compare the pricing of different transactions.

V. Guidance for market benchmarking

This section sets out best practice guidance for DFIs seeking to benchmark their prices to the market. In all cases, DFIs must determine their own commercial strategy, including their precise pricing methodology, independently.

1. Additionality principle of debt provided by DFIs

DFI support to the private sector should make a contribution that is at the limit of, or beyond, what is available privately, or that is otherwise absent from the market, and should not crowd out the private sector. If DFI debt targets an overall return for its debt product that corresponds with the risk/return appetite of private capital investors for a similar investment, this will increase the prospect of crowding-in the private sector.

Guidelines:

- Use external benchmarks* and external ratings to assess an appropriate price and compare DFI target pricing with the risk/return of comparable instruments.
- If an exact and recent** comparable debt instrument is not available, then substantiated adjustments to the target pricing could be made using extrapolation to reflect assumed interest from private investors for that risk.
- In general, the credit margin of the commercial benchmark will include all risks related to the underlying potential investment which may include (but not be limited to) credit risk, liquidity risk and the relatively higher cost of funding of the commercial investors. Therefore, the assessment should take the credit margin as a basis when comparing the DFI target pricing with the relevant benchmark and leave the relatively lower cost of funding of the DFI out of the comparison.

* This could include benchmarks for sovereign, corporate risks, credit default swaps and comparable loan margins in the syndicated loan market.
** Less than 3 months old.

2. Pricing of development impact with concessional funding

Development impact is a primary goal for DFIs. If development impact and cost coverage are the main parameters in the pricing offered by the DFI and such pricing is consequently not market-benchmarked, then this instrument should be considered as concessional funding and the *Enhanced DFI Principles for Blended Concessional Finance* should be followed accordingly.

Guidelines:

- If the target DFI pricing of the offered debt is significantly lower than the market-based pricing of a similar instrument (as established according to the foregoing guidance using market benchmarking), the offered debt product should be considered concessional funding and the *Enhanced DFI Principles for Blended Concessional Finance* should be applied.
- If the target DFI pricing of the offered DFI debt is at par or not significantly lower than the market-based pricing of a similar (as established according to the foregoing guidance using market benchmarking), but the ranking of the DFI debt is structurally and/or legally subordinated, the offered DFI debt should also be considered concessional funding and the *Enhanced DFI Principles for Blended Concessional Finance* should be applied.

3. Internal 'comply or explain' approach to market benchmarking

Given the importance of market benchmarking of prices (except in cases of concessional funding), it is best practice for DFIs to adopt a 'comply or explain' approach internally.

Guidelines:

- Where possible, DFIs should establish knowledge centres to ensure that commercial business units receive independent pricing advice regarding market benchmarking.
- If a DFI does not have such a knowledge centre, it should establish procedures to ensure that the discussion of market benchmarking forms part of its investment decision-making.
- DFIs should establish an internal oversight process to ensure that market benchmarking is applied to investment decisions. Good practice is to adopt a 'comply or explain' principle, whereby the DFI's commercial team is required to explain internally any departure from that DFI's market-benchmarked price recommendation (except in cases of concessional funding).

4. Transparency for commercial market players

Transparency on market benchmarking will help to justify the role that DFIs play in capital markets in emerging economies. DFIs should therefore be able to explain their individual pricing methodologies and the assumptions behind each market-benchmarked price. The usage of concessional funding, instead of market-benchmarked pricing, should be transparent and, if requested by other market players, appropriately disclosed.

Guidelines:

- DFIs should be transparent about the methodologies that they use for market benchmarking of prices.
- Loans that significantly deviate from each DFI's internal rules for market-benchmarked pricing should be considered concessional funding.
- DFIs should develop specific disclosure policies for blended concessional finance, tailored to different stakeholders, that balances transparency with appropriate client confidentiality and DFI efficiency.
- DFIs should consider seriously any feedback from commercial lenders that suggests that their pricing methodology could be distorting markets, to the extent that commercial lenders are unable to enter the same transaction on commensurate terms.
- If appropriate, to meet the additionality principle, DFIs should consider stepping back from transactions in which commercial lenders are actively offering to provide all funding required.
- At all times DFIs must take their own pricing decisions unilaterally and independently, and be mindful that they are independent competitors.

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