POLICY BRIEF

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Updating the DFIs' Operating Models and Methods Towards Helping to Achieve the 2030 Agenda for Sustainable Development

By Franque Grimard and Christian Novak

The United Nations General Assembly set the Sustainable Development Goals already four years ago, and the stakeholders that must play a key role in directing and mobilizing capital to finance the SDGs have not done enough. The public and private sectors should take more actions, and Development Financial Institutions must play a more effective role in contributing to the necessary actions to achieve the 2030 Agenda.

WHAT IS AT STAKE?

The estimated annual amount of investments that are needed to accomplish the 2030 Agenda for Sustainable Development in developing countries ranges from US$ 3.3 trillion to US$ 4.5 trillion. Considering current investment and aid levels, there exists a monumental annual shortfall that is estimated at US$ 2.5 - 3.0 trillion. The shortfall is more severe in relative terms for the low-income countries. Priority sectors education, health and energy are especially undeserved by development financing and aid in large segments of the poorest population. Furthermore, the financing gap is enormous among micro, small and medium-size enterprises (US$ 2.1 - $2.5 trillion of estimated unmet demand[a]) and in infrastructure (US$ 1.5 trillion estimated annual investment needs[b]), which are areas that are fundamental for economic development in developing countries.

Fulfilling the world's common desire to end poverty everywhere by 2030, as well as achieving the rest of the 16 Sustainable Development Goals (SDGs), is at stake.

KEY RESULTS:

Development financial institutions, especially their private sector windows, must play a more effective role in contributing to achieve the 2030 Agenda. In order to achieve such higher needed effectiveness, DFIs must update their operating models and methods, and the most recently launched DFIs, like FinDev Canada, must widely adopt a modernized approach towards development financing. In this regard, we recommend that DFIs:

- Increase mobilization volumes of private capital.
- Widen the offering of financial products and structures with high financial additionality.
- Maximize their investment potential.

We believe that the implementation of the specific recommendations presented in this Policy Brief would significantly contribute to the necessary actions to achieve the 2030 Agenda. However, accomplishing the SDGs is not only dependent on the adaptation of DFIs, but also on complementary effective actions from countries, the international financial system and the private sector, in addition to collaboration among all stakeholders.

In this Paper, we refer as 'DFIs' the national and international bilateral development financial institutions, and the multilateral development banks (MDBs), operating in development countries. The DFIs' Private Sector Windows (PSWs) offer financial products (namely loans, equity investments and guarantees) and advisory services to encourage private-sector development. The PSWs are represented by DFIs that exclusively focus on private-sector operations, and by private-sector divisions within DFIs that have both private- and public-sector operations.

In this Policy Brief we argue that development financial institutions (DFIs), especially their private sector windows (PSWs), must play a more effective role in contributing to reduce the shortfall to finance the SDGs, by mobilizing increased volumes of private capital and by maximizing their investment potential. We also argue that in order to achieve such higher needed effectiveness, DFIs must update their operating models and methods, and the most recently launched DFIs, like FinDev Canada, must widely adopt a modernized approach towards development financing.

PLUS ÇA CHANGE, PLUS C'EST PAREIL

The United Nations General Assembly set the SDGs already four years ago, and the stakeholders that must play a key role in directing and mobilizing capital to finance the SDGs have not done enough. Despite the 2030 Agenda, and especially regarding the signatories' call for action to mobilize additional financial resources from multiple sources, business has overall continued as usual.

Indeed, in relation to actions taken by countries towards domestic resource mobilization for addressing the SDGs, 79 of the 107 national development plans analyzed by the U.N. lack an investment strategy[c]. Countries need to create development plans that are prioritized in their budgets and that are solidly integrated in their national financing frameworks. This is also necessary to attract development financing and private capital. In addition, the Organisation for Economic Co-Operation and Development (OECD) recently indicated a decline in external finance to low-income countries[d], despite the commitments by developed countries to increase flows.

In addition, the international financial system has not taken relevant actions. The financial markets continue to mostly operate under short-term commercial goals, taking a conservative approach towards investing in developing countries. Furthermore, prudential regulations imposed on commercial banks following the 2008 financial crisis made lending to developmental areas like small and middle-size enterprises (SMEs) and infrastructure more stringent. From the approximately US$ 100 trillion managed globally by institutional investors, less than 1% is invested in infrastructure, and only a fraction of this amount is allocated to developing markets. Note that just one percent of global wealth could finance the SDGs. Clearly, there is the potential to do more, and the DFIs have a crucial role to play in unlocking this potential.

Mobilization of private capital: actions taken by DFIs that lead to private capital invested to support development projects.

Financial Additionality occurs when a DFI provides financial products with suitable scale and terms that the market does not provide.

Yet, DFIs currently still mobilize low volumes of private capital, especially their PSWs, which in addition they do so in a limited number of ways. The provision of guarantees remains very low, and the use of financial instruments and structures that have the capacity to result in high financial additionality is minimum. The DFIs' PSWs investments in the more challenging countries, sectors and segments of the population is disproportionately low. Their investment capacities are overall not maximized as a result of prudent use of capital, limited use of the wide range of financial products that exist in the mainstream financial market, and operating inefficiencies. Furthermore, the additionality (financial and/or development) in projects financed by DFIs' PSWs is often questionable, in such cases possibly resulting in crowding out private capital. We believe that DFIs, especially their PSWs, are vital stakeholders in directing and mobilizing capital to achieve the 2030 Agenda. This Policy Brief expands on the matters mentioned in this paragraph and presents our recommendations in the following three areas, which are interrelated and equally important for maximum results:

1) Mobilization of private capital.

2) Offering of financial products and structures with high financial additionality.

3) Maximization of investment potential.

1) Mobilization of Private Capital

Based on an analysis[e] of the 8 largest MDBs' PSWs, their direct and indirect mobilization[1] in 2016 represented $1.5 of private capital for every $1 invested from their own accounts. Direct[†]

[†] This word was corrected from an earlier version of the Policy Brief. Revision done on July 4th , 2019.

mobilization represented $0.40 of private capital for every $1 invested from their own accounts. While these ratios might have increased in recent years, they remain very low, and must grow by a multiple to help address the shortfall to finance the SDGs.

Mobilization ratios can increase as a result of adapted efforts from dedicated teams, and also by using an increased number of mobilization structures. In addition, it is necessary that projects have market terms (including regarding financial returns and tenor), and that they are structured according to market best practices, or else the possible mobilization volumes are limited, in addition to distorting the markets. For example, in the case of infrastructure project financing, the mobilization level of private capital is limited if the leading DFI supports a financing structure that does not appropriately mitigate the project's risks according to the best practices applied by the mainstream financial market. DFIs-led financings with sub-market interest rates and/or tenors have the same effect, in addition to possibly weakening market practices and crowding out private investors.

We recommend that the DFIs' PSWs make use of the broader mobilization structures that exist in the market. There exists tested blended financing[2] structures that DFIs may adopt, and there is ample space for innovation. For many years the mainstream financial sector has been using securitizations, credit-linked-notes (CLNs), collateral loan obligations (CLOs), tailor-structured funds and many by-products of these, which may also be used by DFIs for mobilization purposes. DFIs may also create, seed and manage funds and investing products with investment strategies and structures that are specifically designed to attend private investors' interests. In this regard, some DFIs have launched initiatives that may be adopted by others, like the IFC's Managed Co-Lending Portfolio Program (MCPP)[3] and the AfDB's Room2Run securitization[4], which mobilize private capital by using investing products that are known to the financial sector, structured for the specific type of investments and investors.

IFC's Managed Co-Lending Portfolio Program (MCPP): MCPP leverages IFC's origination capacity and deep market knowledge to source investment opportunities for third-party investors to co-lend alongside IFC on commercial terms, using a variety of offered structures that adjust to the investors' needs.

AfDB's Room2Run: A synthetic securitization of a specific portfolio of AfDB's private sector loans which resulted in the risk-transfer of such loans to institutional investors, resulting in relevant private capital mobilization (and in freeing investment capacity of the AfDB).

In addition, we recommend that the DFIs' PSWs increase their interactions with private capital sources, especially by openly sharing their investment knowledge in ways that are clearly understood by private investors and by proactively proposing structures that address their interests and risk tolerance levels. The DFIs by publicly sharing their risk analysis approaches and considerations can result in private investors concluding more realistically on the level of risks, which combined with specific structuring has the potential to increase mobilization volumes. Our recommendation basically focuses on the DFIs promoting and exploiting more their added-value to private investors, which may be extended to publishing documents that explain how they have resolved problematic investments and what specific lessons learned were captured. Such approach may be effectively complemented by contributing to discussions with governments and regulators in relation to market limitations, including regarding regulations in the financial markets that constrain investments in developing countries or in specific developmental sectors.

[1] In this analysis, 'direct mobilization' is defined as financing from private entities on commercial terms due to the active and direct involvement of an MDB leading to the commitment of private investments, and 'indirect mobilization' is defined as financing from private entities provided in connection with a specific activity for which an MDB is providing financing, where no MDB is playing an active or direct role that leads to the commitment of the private investments.

[2] Blended finance is the use of catalytic capital from public or philanthropic sources to increase private sector investments in developing countries and sustainable development (www.convergence.finance/blended-finance).

[3] http://www.ifc.org/wps/wcm/connect/corp_ext_content/ifc_external_corporate_site/solutions/products+and+services/syndications/mcpp

[4] https://www.afdb.org/en/news-and-events/african-development-bank-and-partners-innovative-room2run-securitization-will-be-a-model-for-global-lenders-18571/

2) Offering of Financial Products and Structures with High Financial Additionality

The DFIs' PSWs have mostly utilized loans as their primary financial product, and, in addition, they have dedicated limited structuring efforts towards maximizing the potential financial additionality of loans. For instance, 'variable payment obligations' and tailor-structured subordinated loans, which are loan products with high financial additionality, are almost inexistent in DFIs' portfolios. Guarantees, unfortunately represent a very small portion of the DFIs' portfolios (with most being low-risk short-term related to trade financing[5]). Yet, guarantees represent a mainstream financial product that possesses a relevant capacity to unlock markets as it allows private investors to gain knowledge in new markets in a prudent risk-mitigated manner to then in most cases invest on a less or fully unsecured basis in follow-on investments[6]. Such unique benefit of guarantees is important as DFIs' additionality is especially maximized when their support not only benefits one project but also future ones.

Numerous structured loans and guarantees that are used by the mainstream financial sector may be adopted by DFIs. In addition, in the last years there has been relevant innovation in the private impact investing space. We recommend that the DFIs' PSWs provide a wider variety of financial products, structured for the specific cases when so may result in higher financial additionality. We also recommend that DFIs incorporate professionals with such specialized experience.

3) Maximization of Investment Potential

DFIs have disproportionately invested in upper and lower middle-income countries as compared to investment volumes in low-income countries, while 18 of the 31 countries that are currently severely off track to end extreme poverty are low-income countries[f]. The current portfolios of most DFIs' PSWs show low investment volumes in low-income countries[7], and they present a portfolio concentration on a few non-low-income countries (including high-income countries). Only 29 of the 47 countries that are designated as least developed countries received financing from DFIs in 2017[g]. Furthermore, in terms of sectors, in particular the SDG priority sectors education, health and energy, DFIs are underserving large segments of the poorest populations. Finally, direct investments in SMEs and infrastructure, which are areas that are fundamental for economic development in developing countries, have also been relatively low.

We believe that the largest limitations to the DFIs' investment potential result from their current operating models. In this regard, we recommend the following:

- Make use of the wider range of financial products that exist in the mainstream financial market (and applying dedicated structuring) to finance projects in countries and/or sectors and segments where the risk level is deemed higher. Carefully selecting the financial products for the specific projects, with suitable structures, can mitigate risks, maximize financial additionality, and mobilize private capital. Additional specialized knowledge and dedicated efforts from the DFIs' investment divisions are necessary.

- Address internal inefficiencies, namely by: a) increasing Board delegation to management in relation to project approvals while strengthening Board involvement in overseeing management functioning and deliverable of the strategy and of the yearly operational and financial plans, b) improving processes by applying the best practices in commercial and investment banking, c) diminishing any existing focus on delivering volumes, d) incorporating additional specialized personnel from the mainstream financial sector, and e) adjusting management decision making process as well as institutional culture and mindset.

We also believe that there is room to increase the utilization of DFIs' capital by:

[5] The MDBs' non trade-related guarantee portfolio may be less than 2-3% of total portfolio.

[6] For example, from the US$ 2 billion loans disbursed under the guarantees that were provided by the USAID's Development Credit Authority (DCA) across 80 countries between 1999 and 2017, only a 2.6% default rate was experienced (www.usaid.gov/sites/default/files/documents/1865/dca_impactbrief2017.pdf).

[7] While we note the US$ 2.5 billion IDA18 IFC-MIGA PSW, which for the 2017-2020 period it is intended to invest and mobilize private capital in the poorest countries with a focus on fragile and conflict-affected states (https://ida.worldbank.org/sites/default/files/pdfs/ida-psw-brief-may-2017.pdf), a limited amount (possibly <US$ 300 million) for only 15 projects has been committed to-date (https://ida.worldbank.org/replenishments/ida18-replenishment/ida18-private-sector-window/ida18-private-sector-window-projects).

- Maximizing their balance sheets by using tools that are commonly used by commercial banks, like securitizations, credit risk insurances, and creation of separate investment funds.

- Increasing risk diversification. Setting up country, sector and product allocations must be part of the development goals.

We believe that as a result, the DFIs' PSWs would increase their investments in underserved countries, sectors and segments of the population, maximize financial additionality, and increase private capital mobilization.

TOWARDS HELPING TO ACHIEVE THE 2030 AGENDA

With the 2030 Agenda in mind, our above recommendations represent our general view that DFIs must update their operating models and methods, and that the most recently launched DFIs, like FinDev Canada, should widely adopt a modernized approach towards development financing. As the current President of the World Bank Group stated while in his previous role: "MDBs must improve the tools and methods they use to analyze additionality, guard against crowding-out, and maximize development impact... In seeking this transformation, we need to challenge the multilateral organizations to rethink their methods and operations."[h]

We also believe that collaboration between DFIs and private investors, as well as among DFIs, must improve significantly. Sharing experience and knowledge among each other, and intentionally working in partnership in complementary roles, can largely help achieve the SDGs. With the objective to improve and increase collaboration, we suggest considering the following ideas:

- Maximize the use of DFIs' donor-funded innovation windows and concessional funding windows[8] that focus on least developed countries and/or underserved sectors and segments of the population, especially by focusing on testing investments that can pave the way for private capital. Such windows house very experienced professionals with successful track record in leading innovation in development financing, resulting in high additionality and unlocking markets. The role of such windows may therefore be further maximized by increased collaboration with DFIs' PSWs windows and private investors.

- Harmonize DFIs' actions, that is, coordinate procedures among each other to avoid duplication. This would namely involve minimizing duplicated due diligence efforts, as well as business origination and investment structuring.

- Launch 'DFIs-private capital funds', and even 'public-private development financial institutions'. The expansion of such kind of possible funds and institutions[9] would naturally force an increased interaction between DFIs (/public sector capital) and private capital, which may contribute to an easier implementation of our recommendations.

- Share among DFIs their own investment financial capacities. When advantageous, DFIs could consider sharing between them any underutilization of their own financial investment capacities. For example, if a DFI is under-utilizing its own financial investment capacity (i.e. under-utilizing is own capital), and this situation is expected to remain for a considerable period, it may consider transferring investment capacity to DFIs that are financially constrained. This could also allow accessing pools of DFI capital that are available for riskier investments, and could also result in additional financial benefits. Although complex, we believe that there could be doable structures and arrangements that are worth exploring.

We believe that the implementation of the recommendations presented in this Policy Brief would significantly contribute to the necessary actions to achieve the 2030 Agenda. However, accomplishing the SDGs is not only dependent on the adaptation of DFIs, but also on complementary effective actions from countries, the international financial system and the private sector, in addition to collaboration among all stakeholders.

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[8] For example, IDB Lab, African Development Fund, International Development Association (IDA), Asian Development Fund.
[9] Some initiatives already exist, including FMO, which is a DFI that is 51%-owned by the Dutch State, 42%-owned by several Dutch banks, and 7%-owned by employers' associations, trade unions and approximately 100 Dutch companies and individual investors.

This policy brief was authored by Franque Grimard and Christian Novak.

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[h] U.S. Department of the Treasury, "Statement of Under Secretary David R. Malpass Before the U.S. House Financial Services Subcommittee on Monetary Policy and Trade," November 2017 (https://home.treasury.gov/news/press-releases/sm0412).

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