Rethinking Private Capital for Development

Romina Bandura

Introduction

The debate on the role of the private sector in development is not new. The need to crowd-in private investments for global challenges was first discussed in the creation of the UK’s CDC Group in 1948 and the International Finance Corporation (IFC) in 1956. Now, there is broad consensus that the private sector is the engine for economic growth, innovation, and progress, generating 9 out of 10 jobs in developing countries. What is novel in this discourse is the central role that private investment can play in financing development.

For a long time, international development focused on increasing the amount of foreign aid, or official development assistance (ODA), to help solve global challenges. During the last 15 years the centrality of ODA as the major source of development financing has shifted. The role of ODA has been redefined as a “catalyst” to mobilize additional investments; while domestic resources of developing countries (taxes, savings, and other revenues) as well as private-sector investments have been promoted for financing development initiatives. Private financing has now become a central component to fund the UN’s Sustainable Development Goals (SDGs).

This recognition is in part due to foreign direct investments (FDI) overtaking the volume of ODA by a factor of 5 to 1. But even the current hundreds of billions of dollars of foreign investment will not be

---


2 This document uses the term “private investment” to encompass private capital (that is, investments in equity or debt securities of privately held companies, real estate, and other assets). Also included in this concept are FDI, remittances and other private sources of funding. See Jonathan Firestein and Sean Olesen, “Private Capital Investing,” Ascent Insights, April 2013, https://ascent.usbank.com/insights/private-capital-investing-january-2013; Blaine McLaughlin, “5 Things You Need to Know about Private Investments,” Huffington Post, May 2015, http://www.huffingtonpost.com/blaine-mclaughlin/5-things-you-need-to-know_7_b_6796256.html.


5 Savoy, Carter, and Lemma, Development Finance Institutions Come of Age.
enough to cover the trillions of dollars needed to meet the 17 SDGs in 2030. More resources will be needed.

Two concurrent trends have further elevated the prominence of private capital in development finance: the aid budgets of major donors have stagnated in recent years and private investors are increasing their appetite for new investments in emerging markets, partly driven by more accommodating investment climates and partly as a result of low interest rates in the mature economies. Additionally, the potential of domestic resources as a source of development funding is growing.

The outstanding question is how private capital can help fill the gap in funding levels for the SDGs, to move financial assistance from the “billions” in ODA to “trillions” in development investments. Donor countries, aid agencies, and development finance institutions can be important players and catalysts to channel private capital into developing countries. Aid agencies are being challenged to offer more innovative products and approaches to enhance the reach of private resources. The recent World Bank Group’s “Cascade” approach announced in April 2017 underscores the use of private-sector finance in development activities. Aid agencies are also exploring financing modalities such as blended finance.

Although there are several institutions, instruments, and innovative approaches that have been designed to channel private capital, barriers for scaling investments to align with development remain. This report analyzes some of the issues surrounding private capital in development. It provides a brief description of the development finance landscape and discusses some of the main limitations that exist in channeling those private funds into developing countries. Finally, it offers a set of broad recommendations for donor countries, aid agencies, and development finance institutions to help channel private capital for development.

I. Financial and Nonfinancial Instruments to Achieve the Billions to Trillions Agenda

Accomplishing the global SDG agenda will require substantial investments. Several costing studies have highlighted the current deficiencies of development financing. Although estimates vary, financing the SDGs will require a global average of $3.9 trillion each year—a shortfall of $2.5 trillion in current annual development investments. McKinsey Global Institute estimated that nearly $800 billion is missing from current annual investments in infrastructure, within and outside of development. These challenges include providing clean water, education, sanitation necessities, and others, which private capital will

---

9 See Wilson, “There’s a $2.5 trillion development investment gap.”
undoubtedly play a role in providing. Without these investments, the widening financial gap could hinder potential growth in developing countries and emerging markets.

The sources of finance will originate from several channels: public and private, domestic, and international, from developed to developing countries or among developing countries ("South-South" flows) (Table 1). This section provides an overview and breakdown of these potential sources of funding together with nonfinancial resources to help catalyze private investments to development.

Financial Resources

<table>
<thead>
<tr>
<th>Public</th>
<th>Private</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>International</strong></td>
<td>Taxes and other sources of public finance for concessional and nonconcessional finance</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>National/Domestic</strong></td>
<td>Taxes and other sources of public finance</td>
</tr>
<tr>
<td></td>
<td>Sovereign wealth funds</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: CSIS based on data from the Organization for Economic Cooperation and Development (OECD), 2014.

- Grants
- Loans and syndicated loans
- Mezzanine finance
- Equity investments
- Risk mitigation instruments
- Shares in investment funds
- Trade finance
- Blended finance
Multilateral Development Banks (MDBs) and Development Finance Institutions (DFIs) play a catalytic role in bringing private investment into developing regions. MDBs are specifically designed to bring development outcomes using a blend of loans, guarantees, grants, and technical assistance and remain a large source of public-sector finance for low- and middle-income countries. On the other hand, DFIs are specialized in providing finance to developing countries with the aim of supporting the private sector.

Concessional financing (or Official Development Assistance [ODA]): Development finance has traditionally been heavily dependent on ODA (public money given outright or loaned on concessional terms) from bilateral donors and multilateral institutions. ODA volumes reached a high in 2016, at nearly $170.3 billion, in part due to refugee costs.\(^{11}\) ODA still plays a prominent role in low-income countries, but as countries develop, this dependence will wane.

Nonconcessional operations: These are financial instruments provided by a range of players (aid agencies, development finance institutions, banks, private investors), at market terms with a commercial motive.\(^{12}\) They include instruments such as:

- **Loans at market rates** are transfers for which repayment is required. They are made from funds raised in the capital markets; these loans use the credit rating of the lending institution to secure attractive terms to developing countries.\(^{13}\) These also include syndicated loans.

- **Mezzanine finance** or hybrid finance refers to instruments relating to the layer of financing between a company’s senior debt and equity, with features of both debt and equity. It includes subordinated loans, preferred equity, and other hybrid instruments.

- **Equity investments** are investments in ownership interests of stockholders in a firm, usually in the form of stocks.

- **Shares in investment funds** are portions of funds that investors usually purchase. Investment funds are institutional units, excluding pension funds, that consolidate investor funds to acquire financial assets.\(^{14}\)

- **Risk mitigation instruments** (guarantees) are financial instruments that transfer certain defined risks from project financiers to creditworthy third parties that have a better capacity to accept such risks. Risk mitigation instruments include credit guarantees, export credit guarantees or insurance, political risk guarantees or insurance.\(^{15}\) According to the OECD, between 2009 and 2011 development guarantees mobilized over $15 billion of private investments to development countries.\(^{16}\)

---

\(^{11}\) This includes bilateral Official Development Assistance (ODA), as well as multilateral ODA. OECD, http://stats.oecd.org/.


\(^{16}\) OECD, Development Co-operation Report 2014, Chapters 4 and 11.
**Blended finance:** is a modality that is gaining importance in some of the DFI’s portfolios and among donor agencies. The OECD defines it broadly as “the strategic use of development finance for the mobilization of additional finance toward the SDGs in developing countries.” The aim behind blended finance is to generate additional and external sources of development finance. The ReDesigning Development Finance Initiative (RDFI) in 2015 identified 74 pooled public and private funds with commitments of $25.4 billion.18

**Domestic Resource Mobilization (DRM):** taxes, savings, capital markets, and other sources of revenue are an important source of financing. Developing countries mobilize domestic sources of revenue and savings toward infrastructure, economic development, and other projects. Estimates of global collected taxes stood at 15.2 percent of total GDP in 2015, or $11.3 trillion worldwide.19 In OECD countries, tax collection averaged 34.3 percent of GDP ($16 trillion) while in low- and middle-income countries only 12 percent of GDP ($3.2 trillion).20 Thus, there is room for developing countries’ tax revenue to expand to fund social, economic, and infrastructure needs.

Within DRM, domestic pools of savings such as local pensions and insurance companies have increased over the last 20 years. In 2013 insurance and pension assets in emerging markets totaled close to $6 trillion: insurance companies had $3.6 trillion of assets under management while local pension funds held $2.4 trillion.21 Channeling these funds into the economies of developing countries—through infrastructure investment, for example—is also a part of the solution for financing development challenges. For example, credit guarantees are an instrument for riskier infrastructure investments to meet the minimum thresholds regulators impose on pension funds and insurance companies.22

**Sovereign Wealth Funds (SWF):** are state-owned investment funds that invest globally in real and financial assets (stocks, bonds, real estate, precious metals, private equity funds, or hedge funds). SWFs receive capital from balance-of-payments surpluses, proceeds of privatization, exports of commodities, and fiscal surpluses. Examples include the Norwegian Government Pension Fund, the Abu Dhabi Investment Authority, the Qatar Investment Authority, the Chilean Pension Reserve Fund (PRF), and the Economic and Social Stabilization Fund (ESSF), to cite a few. SWFs are set up to help stabilize budgets from excess volatility, as a source of savings for future generations and to help diversify incomes from commodity

---

exports. Assets managed by SWFs reached $6.5 trillion in 2016, more than doubling their value since 2008.\(^\text{23}\)

Alongside the mix of official finance for development, the institutions and instruments responsible for finance are also changing. The role of traditional development agencies is now complemented by a slew of private-sector players. Pension funds and insurance companies can mobilize investments by purchasing bonds or local debt, or by investing through DFIs, global and local fund managers and other groups. Institutional investors manage their assets, primarily bonds and equities, and help capitalize on emerging markets and analyzing risks through derivative markets.

**Foreign Direct Investments (FDI):** FDI is an investment in another country for business purposes. Typically, multinational or transnational corporations are authorized users of this transaction type to manage assets and operational activities in those businesses.\(^\text{24}\) FDI flows were nearly $1.8 trillion in 2015, of which $962 billion went to developed countries and $800 billion to developing and transition countries.\(^\text{25}\)

**Remittances:** Remittances are often an indirect source of development financing. Through migration, working abroad, and other forms of mobilization, people from around the world send money between home and host countries. This channel has risen to be a prominent financial outlet because it is often a reliable and consistent source of funds. In 2000, the global inflows of personal remittances were about $121.2 billion, increasing to over $550 billion by 2015.\(^\text{26}\)

**Philanthropy and endowments:** These are small contributions in the grand scheme, but nonetheless significant players in the development financing equation. According to OECD statistics, their contribution has risen from $3 billion in 2003 to $23.4 billion in 2015.\(^\text{27}\) These organizations push their own agendas but nevertheless are advocates for global issues such as education, health, and others. Philanthropy and endowments often are willing to take more risk in developing countries than pure commercial capital, and can help donors crowd-in more risk-averse capital into transactions.

**Global institutional investors:** There are several institutional investors that are expanding the market and accumulating assets in developed and developing economies. These investors include insurance companies, pension funds, investment funds, and others. Institutional investors help solidify development financing and lead to public- and private-sector development, which helps GDP to be more resilient against economic fluctuations.\(^\text{28}\) Pension funds can also be potential investors in emerging

---


\(^{26}\) World Bank, “Personal remittances, received (current US$),” https://data.worldbank.org/indicator/BX.TRW.RMNT.CD.DT.


markets. These pensions seek investments that have favorable returns. The global average returns for the large pension funds surveyed was 7 percent in 2014, and proved beneficial for U.S. stock markets.\textsuperscript{29}

\textit{Socially Responsible Investments (SRI)}: are investments that consider both the financial returns and the environmental, social, and governance (ESG) impacts of business practices. In 2016, the U.S. market size of SRIs alone was $8.7 trillion—nearly 20 percent of all professionally managed investments.\textsuperscript{30} Companies are realizing that ESG investments have good portfolio returns and the responsible investments are beneficial for strengthening company reputation and aligning with company values.\textsuperscript{31} There is also a growing body of evidence suggesting that over the long term, portfolios taking into account ESG factors do not underperform those that do not, and even the more commercially minded pension community is increasingly rightsizing their portfolios for ESG risks.

Nonfinancial Resources

In addition to financial instruments, developing countries need technical assistance to help them improve the investment climate or prepare and mature an investment opportunity. This assistance could range from feasibility studies, technical assistance for policy reforms, as well as capacity building and training.\textsuperscript{32} Aid agencies and DFIs are the primary institutions that can pay for such services.

\textit{Capacity building (training, exchanges)}: For many countries, expertise might be more important than financial sources. Support relies on design and implementation of training programs, staff exchanges, and other mechanisms that are offered to developing country governments and at the enterprise level.\textsuperscript{33}

\textit{Research and data collection}: Aid agencies and DFIs collect essential market data, increasing transparency, strengthening the capacity of intermediaries, and improving the impact measurement systems. Typically, technical assistance facilities also support impact analysis, audits, research, and policy analysis.\textsuperscript{34}

\textit{Regulatory and institutional reform}: Donors, aid agencies, and DFIs provide specific, country-focused advice related to regulatory and institutional reforms. In their guidance, they aim at strengthening the policies and regulations of a country. This technical advice serves as a channel for policy implementation in areas such as governance, compliance with environmental regulations, good business practices, and sustainability.\textsuperscript{35}


II. Challenges in Expanding Private Capital into Development

Despite the growing availability of private capital, and the accompanying institutions and instruments that emerged to help stimulate these flows to development, several challenges remain. Some of the barriers raised by private investors include the following:

Home Country Bias

There remains a large “home country bias”, that is, the tendency of investors to heavily favor investments in their own country of origin in their portfolios when it would benefit to invest in international markets for diversification purposes and for higher returns.

There is asymmetric information for investors and it costs money for fund managers to understand a new space. Not enough “primary” information is collected by investors via international visits and conversations with key decisionmakers and local players in developing countries. Establishing relationships with local policymakers and local institutions would help untangle that “perceptions” problem. In this regard, investment promotion agencies and local chambers of commerce have a significant role to play.

Moreover, there is a considerable “perception” versus “reality” problem in the minds of investors, which reinforces biases preventing finance flows into the developing world. Investors, especially in the United States, receive news on emerging markets from both traditional and nontraditional media. The media generally highlights pessimistic news in their coverage of emerging markets. More often, the coverage is scant. The continent that is less favorably portrayed is Africa. For example, in the last 15 issues of The Economist, between July and September of 2017, African nations were addressed in approximately 7.9 percent of the regional articles compared with Europe and Asia, which constituted more than half of the regional articles. The lack of media attention on the economic and social developments in developing nations has helped create this bias.

An Opaque Legal, Regulatory, and Institutional Environment in Developing Countries

Investing in developing countries also requires a clear understanding of the legal, regulatory, and institutional framework. Laws and regulation pertaining to investments must be transparent, clear, and readily accessible. Cumbersome registration procedures, foreign ownership limits, high transaction costs, corruption, and complex capital market rules are key deterrents for private capital. A sound investment environment includes transparency of its legal framework, protection of property rights, and nondiscrimination. Finally, equally important as having transparent legal systems is the country’s ability to enforce its laws.

In addition, developing countries have very different business and investment standards than those applied to developed markets in the United States and Europe. Although there is a lack of uniformity,

---

37 There are many studies and benchmarks that capture the investment climate in developing countries, including the World Bank’s Doing Business, the Economist Intelligence Unit’s Risk Briefing, among others.
38 OECD, Development Co-operation Report 2014, chapter 12.
39 Ibid.
developing countries are gradually adopting internationally recognized best practices and rules like the Basel Banking Rules, International Accounting Standards (IAS), International Standards on Auditing (ISA), World Bank/IFC Performance Standards, Equator Principles, the UN Guiding Principles on Business and Human Rights, to name a few.40

Country Risk

Country risk refers to the likelihood that political and economic factors will impact country investments. These include political risk (political changes or instability), sovereign risk (the likelihood of government defaulting in its debt commitments), exchange rate risk (risk from exchange rate fluctuations; the inability to convert investments in hard currency), and economic risk (changes in macroeconomic policy). Country risk reduces the expected return on an investment and although there are some hedging instruments available, not all risks are covered and not all the instruments are effective.

In addition to traditional risks, there are other social and environment risks that need to be accounted for. These are factors that are more inherent to the specific sector or industry where the investment will be made. Some sectors are influenced by societal changes or ecological events due to the nature of the activity, for example, aerospace and defense, chemicals, metals and mining, oil and gas, pulp, paper and forestry, and utilities.41 Other investments may fall in sensitive geographical areas such as critical habitats, regions of high conservation value and significant cultural heritage, locales with indigenous peoples, and areas under conflict.42

Underdeveloped, Dysfunctional, or Nonexistent Domestic Capital Markets

Markets where investors can buy and sell financial instruments, such as securities and bonds, are nonexistent in developing countries or not well developed: they lack liquidity and scale (i.e., small number of publicly traded firms, low value of traded securities, and heavy reliance on traditional sources of finance, such as bank loans and profits). The stock market capitalization of middle-income countries in 2016 relative to GDP is about 60 percent while for high-income countries it is double.43 In Africa, 17 countries out of 54 (31 percent) have stock exchanges while in Latin America and the Caribbean, 24 countries out of the 33 (73 percent) have stock exchanges.44 These regions’ financial markets also lack depth (measured by market capitalization plus the amount of outstanding domestic private debt securities as a percentage of GDP).45 Without well-functioning local capital markets, investments are more difficult to flow because of the lack of options for exits. Moreover, despite and liquid local capital markets can better

intermediate savings and investment, and lead to a reduction in aid reliance by recipient countries. Deeper capital markets also contribute to overall resiliency.\textsuperscript{46}

Stock exchange activity is a factor in global financial integration and increasing capital flows across countries to promote economic development. The top 10 stock exchanges (NYSE, NASDAQ, Euronext, and the stock exchanges of London, Tokyo, Shanghai, Hong Kong, Toronto, Shenzhen, and Frankfurt) have a total market capitalization of nearly $53 trillion.\textsuperscript{47} An academic study found that countries with active stock markets had significantly lower levels of poverty and inequality: a 1 percent higher level of equity-market activity was correlated with a 19 percent higher share of the country’s income earned by the poorest decile and a 6 percent lower share going to the top decile.\textsuperscript{48}

Institutional Barriers within Aid Agencies

Although aid agencies, and in particular DFIs, are important players and catalysts to funnel private capital into developing countries, common concerns related to the way they conduct business include timing issues (slow and bureaucratic processes), lack of flexibility in their approaches, inadequate instruments, and a lack of coordination among the different players: bilateral and multilateral institutions (such as IFC, MIGA, and others). For example, transaction advisory services have multiple phases and in some cases, it can take up to 20 months from design to execution.\textsuperscript{49}

III. Expanding Private Capital into Development: Key Recommendations

The benefits of engaging private capital in development would comprise higher returns for investors and greater economic and social welfare for developing countries. Moreover, it would forge more prosperous alliances and build a pro-business, pro-reform constituency in countries. This brief section provides some recommendations for how donor countries, aid agencies, and DFIs can overcome these barriers. How can aid agencies and development finance institutions use existing instruments more effectively? How can they make private investments scalable? What instruments and approaches should they pursue?

Recommendation #1: Help investors navigate emerging market opportunities

Each investment is context-specific and international investors looking to diversify their portfolios in emerging markets need better information on the country context. Aid agencies and DFIs could be facilitators in overcoming information asymmetries and negative perceptions when investors approach frontier markets. Pension fund managers in developed countries need to be in contact with the actual projects and have personal interaction with local fund managers. Supporting in-country visits,


\textsuperscript{49} IFC Transaction Advisory Services, “From Concept Design to Project Execution” (presentation to ECOWAS Centre for Renewable Energy and Energy Efficiency [ECREE], Abidjan, March 2014), http://www.ecreee.org/sites/default/files/event-att/140317_ecreee_ppp_presentation.pdf.
triangulating conversations with local experts and country officials, and facilitating professional exchanges are some steps that could be taken. Institutions such as local chambers of commerce, investment promotions’ agencies, aid agencies and DFI s have a role to play and could serve as conduits/ambassadors in this endeavor. Moreover, DFI s and MDBs need to offer more opportunities for private investors to co-invest and participate in their syndicates—leveraging their expertise in these markets. IFC’s Managed Co-Lending Portfolio Program (MCP P) is a new syndication product that allows institutional investors to passively participate in the institution’s future loan portfolio: investors provide capital on a portfolio basis, which IFC allocates in individual investments across all regions and sectors.\textsuperscript{50}

Another challenge that investors face is understanding the legal and regulatory intricacies related to investing in capital markets in developing countries. Opaque and cumbersome legal frameworks work against the economic interests of the developing country. Improving the flow of information and helping create transparent and clear capital market rules would be a major positive step to help attract private funding. DFI s and aid agencies could play an intermediary and information facilitator role between the developing country and the foreign investor. Moreover, they can provide technical assistance to governments in legal and regulatory reform to make the investment climate “friendlier.” Developing countries are ultimately responsible for generating the required information, establishing the legal conditions, and enabling the environment to attract both foreign and local investments. But aid agencies and DFI s can facilitate this process. By facilitating transactions these institutions can help to apply pressure to make changes in countries’ legal framework. MDB or DFI involvement can also be a deterrent or prevention mechanism against corruption or at least they put pressure on governments to address it.

Most notably, a challenge that institutional investors face is navigating the domestic securities and bonds markets and their related risks. For example, emerging market corporate bonds (debt issued by firms in developing countries) have gained prominence with their stock valued at over $1.6 trillion versus the U.S. high yield market (valued at $1.3 trillion).\textsuperscript{51} These bonds have higher yields compared to U.S. corporate debt and Treasury bonds but they also carry higher risks.\textsuperscript{52} Agencies such as Standard and Poor’s and Moody’s assess risks through rating systems while investment banks and institutional investors have developed indices that track their performance (for example, J.P. Morgan’s Emerging Markets Bond Index Global (EMBI Global), and the Corporate Emerging Markets Bond Index (CEMBI)).\textsuperscript{53} However, not all countries are covered and not all local corporate bonds get internationally rated.\textsuperscript{54} Donors and aid agencies could work with rating agencies and offer technical assistance to develop such assessments improving the information available to institutional investors looking for ways to diversify their portfolios. Moreover, aid agencies and DFI s could support the information flow to investors by publishing

\textsuperscript{50} See IFC, “Managed Co-Lending Portfolio Program (MCP P),” http://www.ifc.org/wps/wcm/connect/corp_ext_content/ifc_external_corporate_site/solutions/products+and+services/syndications/mcpp.


the relevant data, legal templates, and financial models from sponsored transactions to help reduce the
cost to future investments and facilitate transactions.

Recommendation #2: Assist in developing local capital markets

Domestic savings in developing countries have increased over the last 20 years. In middle-income
countries bank deposits as a percentage of GDP increased from 23.5 percent in 1995 to 42.5 percent in
2015. While in low-income countries this figure climbed from 12 percent to 18 percent in the same
period. In 2013, developing countries’ domestic bank assets, bonds, and equities composed 20 percent of
global domestic assets. Additionally, according to Credit Suisse’s 2016 Global Wealth Report, 18 percent of
the world’s ultra-high net worth population is in emerging markets. The Economist reports that in 2004
20 percent of the 587 billionaires in Forbes magazine’s annual survey were from emerging countries while
this figure rose to 43 percent by 2014 (out of 1,645 billionaires). The potential of domestic resources as a
source of development funding is growing.

To generate more confidence in the local market, domestic investors need to signal “outsiders” by
investing in their home countries. For example, local insurance companies buying domestic bonds or local
fund managers channeling domestic savings. However, as mentioned earlier, local capital markets are not
well developed around the world and this is an area where aid agencies and DFIs could continue making a
difference.

Technical advice, staff secondments, professional exchanges, and creating public-private partnerships
(PPPs) are some ways that aid agencies and DFIs (working with institutional investors) can assist
developing countries in creating more solid capital markets to channel both local and foreign
investments. For example, municipal bond underwriters could help developing countries with capital
transactions via professional secondments. Or local pension funds could host a series of professionals and
technical advisers to receive knowledge and expertise on financial products and capital market
development.

The U.S. Agency for International Development (USAID), the IFC, and others have supported the
development of local capital markets through the issuance of local currency bonds, including in countries
like Rwanda, Indonesia, Zambia, and Nigeria. A key opportunity is to use credit guarantees to support
the development of local bond markets. For example, the Swedish International Development Agency
(SIDA) provided a corporate bond guarantee for a telecom company (MTN) in Uganda to expand mobile
access in rural areas.

56 Daniel Runde, “There’s Never Going to Be Enough Aid to Develop a Country,” Forbes, October 9, 2015,
57 See Richard Kersley and Antonio Koutousakis, Global Wealth Report 2016 (Geneva: Credit Suisse, 2016), https://www.credit-
rags-riches-appears-more-achievable-developing-asia.
markets-drive-growth/#7ef54fed314b.
60 Although the transaction was not completed, USAID’s Development Credit Authority helped structure a 50 percent credit
guarantee for the city of Dakar (Senegal) in a $41.8 million local currency municipal bond issuance to improve and formalize a
Recommendation #3: Develop creative products and approaches to facilitate private investment in frontier markets

Donor countries, aid agencies, and DFIs are being challenged to offer more innovative products and approaches to channel private resources into global challenges. This includes new instruments, taking on more risks and coordinating closer together to enhance their reach and impact.

Blended finance is gaining popularity among aid agencies and DFIs. This approach has three main characteristics: (i) it leverages development finance and philanthropic funds to attract private capital into deals; (ii) the investments made have social, environmental, and economic impact; and (iii) the investments have financial returns in line with market expectations, based on real and perceived risks. The 2016 World Bank’s IDA 18 replenishment allocated $2.5 billion for IFC and the Multilateral Investment Guarantee Agency (MIGA) to rebalance the risk-reward profile for private-sector projects in the poorest countries, and fragile and conflict-affected situations. IDA 18 also included a blended-finance facility to mitigate various financial risks by providing loans, equity, and guarantees to pioneering IFC investments across sectors. USAID’s new blended finance mechanism—INVEST—is a flexible buy-in mechanism that allows the USAID missions to access in a more efficient and quicker manner the expertise needed for the design, deployment, and evaluation of blended-finance approaches that use government funding more strategically to crowd-in private capital. Other blended-finance initiatives include the Green Climate Fund, the EU blending facilities, and Convergence, among many others.

Another instrument that could support the expansion of private investments in emerging markets would be securitizing a portion of DFIs’ loans. Securitization pools assets (i.e., loans) and repackages them into marketable securities. When the pooled assets are sold, these are removed from DFI’s balance sheet and as tradable securities, they become attractive to other investors. Securitization of existing DFI loans and their sale to institutional investors, who are increasingly looking for emerging market yields and exposure, would accomplish a number of key objectives at once. First, unlike various fragmented efforts thus far by DFIs to engage and crowd-in large pools of institutional capital, securitization of existing loans would achieve the scale and diversification that investors require all at once and at less cost. The DFI portfolios are some of the best rated in developing economies and have a number of attractive preferential terms attached to them. Second, it would allow institutional investors who perceive developing market investments as high risk to take a measured step into these markets with credible DFI partners, allowing them to overcome home-country bias and unproven perceptions of risk. Third, through securitization the DFIs would achieve the balance sheet headroom they need to recycle their capital and jump-start their lending operations, further closing the SDG investment gap by billions and even trillions of dollars over time without additional capital replenishment from donors. Portions of DFI securitizations could also take place on local capital markets, providing the added benefit of deepening these markets and allowing local pension and insurance companies to deploy more domestic resources towards their own development.

community market. Also see SIDA, “Guarantee Example Corporate Bond,” 2015, http://www.sida.se/contentassets/01c9a39f38ab44047809981ab2daaf2c2/ce49f12a-74e9-47a4-807a-a5d0a1899dd.pdf.
61 OECD and WEF, Blended Finance: Vol. 1.
A third area that could help channel private investments into developing countries is expanding the offering of guarantee products to mitigate new risks (such as environmental and social risks) or to enhance investments in local currency. The Ascending Markets Financial Guarantee Corporation (AMF) provides guarantees for the repayment of principal and interest for creditworthy bond issues and bank loans in local debt capital markets around the world in transactions that involve health care, education, municipal debt, and infrastructure, to name a few. Institutions like World Bank’s MIGA, the IFC, and the Overseas Private Investment Corporation (OPIC) can develop new types of guarantees and offer them in a more coordinated way.

Recommendation #4: Better coordination among donor countries, aid agencies, and DFIs

An area often cited is closer coordination of institutions to enhance the reach and impact of private capital. In the case of the United States, the major aid agencies involved in development finance include OPIC, USAID, the Millennium Challenge Corporation (MCC), and U.S. Trade and Development Agency (USTDA). An earlier CSIS report advised that these agencies expand their authorities, work more collaboratively, and use their resources more creatively (Box 1).

<table>
<thead>
<tr>
<th>Box 1: Increasing the reach and effectiveness of U.S. government aid agencies: Key recommendations</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Reauthorize OPIC on permanent basis (not just annually) or at least for a five-year term and allow it to retain a small portion of its earned revenues to fund technical assistance programs tied to OPIC investment products, permit OPIC to participate in “first loss” and other forms of risk sharing, and enable a limited capability to make equity investments in frontier markets.</td>
</tr>
<tr>
<td>• USAID and MCC need to use grant money in ways that share risk on development finance deals consistent with host countries’ development objectives.</td>
</tr>
<tr>
<td>• Revisit the use of Enterprise Funds (i.e., U.S. government dollars funding private equity investments in emerging markets) in several countries that would deem strategic for the United States</td>
</tr>
<tr>
<td>• USAID to work closer and more strategically with OPIC and USTDA in exit plans for closure of its missions. Moreover, OPIC and USTDA need to be included in the frontend of MCC compact development.</td>
</tr>
<tr>
<td>• Encourage a system of secondments across agencies so that staff understand the way each agency works and to promote a stronger collaboration in the future.</td>
</tr>
</tbody>
</table>


Investors often highlight the need for greater involvement and coordination among aid agencies and DFIs in developing and structuring bankable projects, that is, projects that are profitable and sustainable in the long run. Projects in developing countries in sectors such as energy, infrastructure, and public service space are complex and need more structuring. Aid agencies have their own facilities at distinct stages of the project cycle to help increase the pipeline of bankable projects in developing countries. For example, the Inter-American Development Bank (IDB), the European Bank for Reconstruction and Development (EBRD), and others have their own project preparation facilities. The USTDA has a project preparation program that funds feasibility studies, pilot projects, and technical assistance for development projects. Since 2008, IFC has a project development fund for infrastructure—the IFC InfraVentures—which

combines early stage risk capital and project development support. What is less clear is whether these aid agencies have mechanisms to share resources and coordinate with each other on projects to gain efficiencies and create greater scale of bankable projects. Instead of creating new facilities in each of the aid agencies, they could improve the effectiveness and coordination of those already in existence.

Another area where DFIs and aid agencies can work together is in implementing blended-finance initiatives. These institutions have their own competitive advantages and together they can maximize their impact. DFIs have a long history of investment experience and offer skills and competencies that can be used in structuring such facilities. Aid agencies have more experience in fragile settings and frontier markets and thus can offer those skills needed to help DFIs gain experience in these kinds of markets. They can provide different and complementary types of resources such as grants versus equity and debt.

Finally, aid agencies and DFIs can gain efficiencies by standardizing some of their analytical products such as country assessments, due diligence, and impact evaluations. This would allow these institutions to gain efficiencies as a group, reduce the amount of resources directed to such activities, and help host governments reduce the bureaucratic requirements involved in their transactions.

Conclusion

Private capital can help to fill the gap in funding levels for the SDGs, to move financial assistance from the “billions” in ODA to “trillions” in development investments. There are several challenges for private capital to flow into development including home-country bias for foreign investors, a nonconducive legal environment and investment climate in developing countries, high country risk, and underdeveloped domestic capital markets. Aid agencies and DFIs can be instrumental in overcoming these challenges via their transactions or technical assistance they provide.

Donor countries, aid agencies, and DFIs can be important players and catalysts to funnel private capital into developing countries. They use a variety of financial and nonfinancial instruments to help mobilize private resources. However, these institutions also face shared criticisms related to the way they conduct their business, including timing issues (slow and bureaucratic processes), lack of flexibility in their approaches, inadequate investment instruments, and a lack of coordination among the different players.

These agencies have been exploring innovative ways to leverage development private finance by sharing risk and reducing costs involved. Helping investors navigate emerging market opportunities by improving the flow of information and creating transparent and clear capital market rules, assisting in the development of local capital markets, developing creative products and approaches to facilitate private investment in frontier markets, and improving coordination among donor countries, aid agencies, and DFIs are ways that these institutions can enhance their catalytic role.

---

69 Savoy, Carter, and Lemma, Development Finance Institutions Come of Age.
Acknowledgments

This report is made possible by the generous support of the U.S. Agency for International Development (USAID).

We thank the participants of the roundtable held at CSIS on September 21, 2017, for their contributions. This report builds on earlier CSIS publications on the topic such as Sharing Risk in a World of Dangers and Opportunities: Strengthening U.S. Development Finance Capabilities (2011) and Development Finance Institutions Come of Age: Policy Engagement, Impact and New Directions (2016).

We thank Brunilda Kosta and MacKenzie Hammond for their research assistance.

We also thank our peer reviewers: John Simon (TOTAL Impact Capital), Jake Cusack (CrossBoundary), Nathan Kelly (CrossBoundary), and Mildred Callendar (OPIC) for their comments.

About the Author

Romina Bandura is a senior fellow with the Project on Prosperity and Development at CSIS.

This report is produced by the Center for Strategic and International Studies (CSIS), a private, tax-exempt institution focusing on international public policy issues. Its research is nonpartisan and nonproprietary. CSIS does not take specific policy positions. Accordingly, all views, positions, and conclusions expressed in this publication should be understood to be solely those of the author(s).

© 2017 by the Center for Strategic and International Studies. All rights reserved.