PART II

Chapter 11

Using financial instruments to mobilise private investment for development

by

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This chapter describes a range of financial instruments increasingly used by public development finance providers to mobilise resources for investment in developing countries. It focuses on the functioning of pooling mechanisms, guarantees and equity investments, and their potential to mobilise private investment in key sectors such as infrastructure.

This chapter also includes two opinion pieces. The first is by Pierre Jacquet, President of the Global Development Network, on how official development assistance should be used to enhance risk sharing between the private and public sectors. The second is by Owen Barder of the Center for Global Development on stimulating private investment by ensuring genuine returns for success.
Development agencies and bilateral and multilateral development finance institutions (see Chapter 4) have been exploring a range of ways to leverage private finance for development by sharing the risk and reducing any costs involved. This chapter outlines and explains three promising approaches:

1. **Pooling mechanisms:** Pooling numerous types of finance from both public and private sources can result in larger volumes of investment capital and/or longer term loans.

2. ** Guarantee schemes:** Guarantees can improve a project’s financial viability and lessen the risk involved, thereby attracting additional investment.

3. **Equity and mezzanine finance:** By investing in risk capital, public investors can reduce the risks for other investors, thereby promoting additional finance alongside their investment.

All of these financial instruments can help build the confidence of potential private investors in situations that might otherwise seem too costly and/or too risky. Yet to be effective, they need to be accompanied by policy reform to create a conducive business environment – e.g. with sound regulatory and legislative frameworks, reliable payment mechanisms, clear underlying tariffs and transparent bidding processes – for public and private investment. The question of how to create an enabling environment for investment through policy reform is discussed in Chapter 12.

**Pooling resources allows for large-scale investment**

Developing countries need investment in infrastructure. Yet the large volumes of finance required, coupled with the risky and often long-term nature of infrastructure projects, can make these unattractive to private investors operating alone. Bilateral and multilateral providers of development co-operation are exploring ways to use public funds to bring public and private finance on board through financial solutions such as blended loans, syndicated loans and securitisation – all explained below.

**Blended loans are helpful for financing low-return projects**

Blended loans offer a middle ground between pure grant and finance at market rates; they mobilise public finance by mixing budget funds (i.e. grants or subsidised loans) with additional funds raised from other sources (e.g. capital markets). Blending loans in this way can generate much larger financial packages than can be made available only through grants. This is especially useful for projects that are economically viable and have a clear developmental impact, but that do not generate high enough returns to be bankable on commercial terms, given perceived risk levels.

**Blending grants and market loans can generate much larger financial packages than can be made available only through grants.**

Because they combine a concessional and a non-concessional component, blended loans soften the terms and conditions of the financial package (e.g. lower interest rates, longer tenor). In this way, they make a loan “cheaper” for the borrower. This may also help to attract private equity finance to underpin the overall finance package.
Blended mechanisms are increasingly used by multilateral development banks (e.g. the World Bank, Inter-American Development Bank Group), the European Union (Box 11.1) and bilateral development finance institutions (e.g. European Investment Bank, Agence Française de Développement, or the German government-owned development bank – KfW).

Box 11.1. How the European Union leverages additional financing for development

Investment needs in European Union (EU) partner countries are substantial – far higher than can be covered by governments’ own resources (e.g. ODA). Blending is an important vehicle for leveraging additional resources and thereby for strengthening the impact of EU action. By blending EU grants with non-grant financing, additional public and private resources can be leveraged to drive sustainable inclusive economic growth as a basis for poverty reduction.

Over the past seven years, seven EU regional blending facilities have been established. Close to EUR 2 billion in EU grants went to support more than 200 investments in economic and social infrastructure as well as private sector development. EU grants were blended with loans and equity from public finance institutions, contributions from partner countries, as well as private resources. This blending of different financial resources is helping to unlock investments with an estimated volume of EUR 40 billion.

While so far most of the leveraged financing is public, realising the potential of blending to mobilise private financing will also be important to support local businesses and help fund infrastructure projects, which are subject to many risks that deter private investment. Risk-sharing mechanisms can mitigate those risks, leading to lower financing costs. They can also make local financial markets more inclusive, allowing direct financing for previously unserved local businesses.

In December 2012, the EU Platform for Blending in External Co-operation was launched to increase the effectiveness of blending in EU external co-operation. The work of the platform includes reviewing existing blending mechanisms, enhancing the technical and financial analysis of projects, developing indicators for measuring results, and assessing the potential and risk of private financing.

Source: This box was provided by EuropeAid.

Lenders can reduce their risk through syndicated loans

A syndicated loan is provided by a group of lenders (the “syndicate”), spreading the borrowing across lenders who would not have been able to provide the same loan amount and/or terms on their own.

Syndicated loans are commonly used by multilateral development finance institutions (see Chapter 4). They are made up of two parts: a loan provided by a development finance institution (the “A lender”) and one or more loans made by commercial banks or institutional investors (the “B lenders”). Because of their special relationships with their borrowing governments, multilateral development finance institutions benefit from tax immunity and “preferred creditor” status (member governments grant the loan providers preferential access to foreign currency in the event of a foreign exchange crisis). When financial institutions participate as B lenders in a syndicated loan they benefit from this same status, thus taking on less risk than if they were to lend on their own. Participation by a development finance institution in the syndicate can also lower borrowing costs and allow developing countries a longer repayment period.
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Attracting new sources of financing through securitisation schemes

Securitisation is the process of pooling assets, such as loans, and re-packaging them into marketable securities. The main objective of securitisation is to make additional capital available to borrowers who cannot grow further, either because they are not able to access affordable bank loans given their risk profile or because they have reached maximum debt-to-equity leverage or debt exposure limits. When the pooled assets are sold, they are removed from their balance sheet. By transforming them into tradable securities, they become attractive to other investors. Although its use by development finance institutions is limited, partly because of the negative experience with subprime mortgage backed securities in the United States, securitisation is extensively used in Islamic finance to issue asset-backed securities in a form called “sukuk”.

Sukuk comply with sharia requirements of risk-taking and sharing of profit and losses (value and income depend on the performance of the underlying assets), and thus have the potential to attract Islamic investors, who are a growing source of financing for many developing countries. For example, in 2009 the Central Bank of Kenya issued its first infrastructure bond for a total amount of USD 222.8 million, of which nearly USD 12 million was a sukuk tranche (MIFC, 2013).

Guarantee schemes reduce investor risk

Guarantee schemes – a mainstay of international financial markets for many years – help mobilise finance by transferring or mitigating risks that private investors would not be able or willing to take. Guarantees act as a type of “insurance policy” against the risks of non-payment, facilitating financial flows to developing countries and high-risk sectors (see the “In my view” box by Pierre Jacquet). They are particularly beneficial to developing country businesses, which often lack creditworthiness in the eyes of private investors (Box 11.2).

Guarantees for development supported USD 15.3 billion of private investment in developing countries between 2009 and 2011.

Although the use of guarantees for development purposes by development finance institutions has expanded in recent years, its potential remains largely untapped (Mirabile et al., 2013). A recent OECD survey of resources mobilised by guarantees for development purposes revealed that:

- While guarantees for development supported USD 15.3 billion in private investment in developing countries between 2009 and 2011, this amount was marginal when compared to ODA. For example, net ODA in 2011 alone was USD 134 billion – more than 20 times the volume of risks covered by development guarantees.
- Most of the private capital mobilised by guarantees was sourced from banks, investment funds or companies domiciled in OECD economies. This points to the scope for making greater use of development guarantees to tap local savings and capital markets in developing countries.
- Most development guarantees surveyed covered risks in middle-income countries, where conditions are well-suited for the use of market-based instruments to mobilise private capital. Furthermore, financial services, infrastructure and industry accounted for more than 70% of the resources mobilised.
Middle-income countries in Africa benefitted most from guarantees, followed by Asia and Eastern Europe: contracts issued in Africa were significantly smaller than those issued in other regions, however.

More than half of the resources mobilised were guaranteed by international financial institutions; this is likely a result of their: 1) strong treasury and co-financing operations; 2) leading role in infrastructure/big ticket investments; and 3) comparatively larger average guarantee exposures.

**Box 11.2. International Finance Corporation's partial credit guarantees**

International Finance Corporation (IFC) guarantees are a key instrument both to provide clients with access to funding that they would otherwise find more difficult (or impossible) to obtain and to facilitate the development of local capital markets in emerging countries. IFC guarantees can be used on both bond and loan instruments, and for both local and foreign currency cross-border transactions. Partial credit guarantees generally are – in the IFC’s view – the most appropriate instrument for meeting client needs and promoting the development of local capital markets; however, in selective cases, the IFC can also provide full guarantees.

Guarantees have important uses and benefits for both borrowers and investors.

For borrowers, IFC guarantees:

- enable clients to achieve higher credit ratings on bond issuances
- assist first-time bond issuers to establish their name in the market with key institutional investors
- improve bond placement outcomes for clients, as investors often value the full due diligence the IFC performs on each client and the surveillance it provides for the life of the transaction
- facilitate borrowers’ access to investment funds outside the formal banking system (such as pension funds); allow the IFC to mobilise local currency resources for clients.*

For investors/lenders, IFC guarantees:

- provide local pension funds and insurance companies with high-quality instruments that meet their credit quality requirements, in which they would not have been able to invest otherwise
- help banks to lend more by reducing the amount of risk borne by the bank on loans to the IFC’s clients.

Importantly, the IFC views its guarantees primarily as market access, credit enhancement and exposure management products, and not necessarily as money-saving structures for clients. Because the IFC evaluates and prices its guarantees based on an individual assessment of the credit risk of the client and other relevant factors – and charges fees based on this assessment – there may not always be significant cost savings for the client relative to other financing alternatives. The value of the guarantee lies, rather, in the benefits outlined above, backed by the IFC’s long-standing global expertise in working with arrangers, credit rating agencies and other capital market participants to structure efficient transactions that meet the needs of both borrowers and investors/lenders.

* Where it is not possible to hedge an IFC-funded local currency loan or bond investment.

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In my view:
ODA should be used to enhance risk sharing between the private and public sectors

Pierre Jacquet, President of the Global Development Network

An important argument in favour of redefining official development assistance (ODA) is that its current definition, based on grants and concessional loans above a given degree of concessionality, somehow pre-determines the nature of what it should be used to finance. In other words, the instrument drives the content: grants and loans naturally call for concrete counterparts in the form of development projects elaborated in order to request such ODA support. This encourages donor governments in their natural tendency to think of themselves as direct and autonomous development actors and to feel accountable for that role.

Such an instrumentally pre-determined approach to ODA presents substantial drawbacks. Given the political pressure to declare high figures for ODA, it discourages the use of taxpayer money for any non-ODA declarable instrument. Yet, current ODA-declarable instruments are not adequate to catalyse and attract other actors and potential funders. Expanding the range of declarable instruments toward more innovative development finance could help further mobilise market forces and private investments behind development objectives.

Some private decisions not to invest in developing countries may be informed by proper and well-documented risk analysis, in which case no compensatory public action is justified on economic grounds. Some, however, may be based on market failures; for instance, a lack of proper information, of contract enforcement mechanisms, of expected profitability due to insufficient complementary investments or of proper insurance mechanisms. In these instances, there is a strong case for using public money to create risk-sharing mechanisms between the private and the public sectors.

The mission of the private sector is not to promote public goods, whether local or global, but the provision of such goods will often benefit from the technical and managerial savoir-faire, as well as the financial might, of the private sector. Creating opportunities for revisited “public-private partnerships” will have to rest on complex contractual relations that involve formulation and implementation challenges. Public money may help reconcile private profitability objectives with the additional costs involved in providing public goods benefits.

In my view, risk mitigation is at the core of a modernised, reinvented role for ODA. Better risk analysis and coverage is likely to attract private investment and support local entrepreneurship. This is based on the underlying assumption that available market instruments and spontaneous private decisions do not allow for mitigating risks in an effective way, and that this results in under-investment. For example, farmers in poor developing countries may not be able to use their future crop, considered as too risky, as collateral and may as a result be too constrained financially to buy the fertilisers necessary to increase production. Offering a guarantee may help.

More generally, ODA should be used to provide insurance, guarantees, risk-sharing instruments, debt instruments with “counter-cyclical provisions” to smooth various external shocks (for example, diminution of the required debt service in years in which a shock affects the debtor’s capacity to pay), etc. There are market-based ways to account for the modernised use of ODA. Significant capacity development would be needed in development agencies to permit careful assessment of potential market failures, as well as careful risk and moral hazard management. Errors may be made along the way, but the promise of engaging new markets and private actors makes these efforts to modernise more than worthwhile.
**Public sector investment in risk capital mobilises additional finance**

Investment in risk capital – equity and mezzanine tranches – is key for new or expanding private companies to start a business, provide a stable long-term funding basis and protect creditors who ground part of their lending decision on the availability of significant equity. Nonetheless, this type of investment is often deemed too risky by the private sector unless the public sector steps in to share the risk (though there are different ways of viewing this support – see the “In my view” box by Owen Barder further below).

Public investors can take equity stakes directly in a company by purchasing a share of ownership, or indirectly by investing in equity or debt funds. Doing so reduces the risk for creditors, who will be repaid before equity holders. Higher equity capital allows the investee company to improve its solvency, meaning it can acquire debt from domestic or international commercial banks. Highly rated investors (e.g. development finance institutions) increase the creditworthiness of the investee company because of their prudent financial management and adherence to sound governance standards (see Chapter 4). They are also expected to support the company, even in challenging times.

Investment funds can either have a flat structure – in which all shares have the same profile with respect to risks, profits and losses – or else structure the capital into tranches, with different levels of “seniority” (i.e. order of repayment in the event of sale or bankruptcy; Figure 11.1). Structured investment funds allow investors to invest according to the risk they can carry and returns they seek. The most “junior” tranche of capital (Figure 11.1) absorbs the highest risk. Investors in this tranche thus provide a “first-loss guarantee” to other investors in more senior tranches. Investors in the next (and riskier) tranche provide an additional risk cushion to more senior investors above them. This mechanism effectively spreads the risk and creates new investment opportunities for private investors by creating tranches with risk and return profiles that match their investment criteria.

![Figure 11.1. Risk levels of structured capital](image-url)
In my view:

Returns for success are the best means of stimulating private investment

Owen Barder,
Center for Global Development

Promoting private investment may be an effective way of accelerating economic development and access to public services for the poor. Donors and multilateral finance agencies have reported to the OECD that they have used loan guarantees to bring in USD 15.3 billion from the private sector between 2009 and 2011.

But are guarantees the best way to crowd in private investment? They make sense if you believe the market overestimates the risks of investing in developing countries and that official agencies systematically judge these risks better. Even if you believed both parts of this, though, wouldn’t you first want to exhaust other options to achieve the same results without paying to protect investors from risks?

Private investment stimulates positive social benefits – such as jobs and economic infrastructure – which go beyond private returns. But when social returns exceed private returns, the private sector will tend to invest too little. The most effective policy response to this is normally boosting returns, not mitigating risk. There are ways that governments can do this, some of which have been pioneered by the Center for Global Development.

Development impact bonds, for example, are being implemented to improve education outcomes in Rajasthan and tackle sleeping sickness in Uganda by guaranteeing public payments for private success. The Advance Market Commitment (AMC) for vaccines has given pharmaceutical companies reason to invest in research and development for vaccines that would otherwise not pass the cost hurdle because their main customers are poor. Such contracts reward the private sector for what they achieve.

Schemes that provide rewards are often a better way to attract private investment because they encourage investors to take risks, recognise failure, adapt and learn. By contrast, it is difficult to see how guarantees that reduce risk to investors won’t simultaneously weaken the private sector’s incentives to do well the very things we want them to do.

Loan guarantees also tend to be blunt instruments: they are offered to a particular firm, which requires policy makers to pick winners. Mechanisms that augment returns, by contrast, can be open offers, leaving it to the market to determine who provides the service and receives the subsidy. These payments can also be more tightly targeted at social benefits for the highest priority beneficiaries, whereas it is hard to vary the benefits of loan guarantees in proportion to the achievement of social objectives.

Increasing the returns for success is also politically attractive. Paying out only if a project delivers results is much easier to defend to a sceptical public than loan guarantees that bail out failed investments.

If we really want to see greater private investment in developing countries, we have more powerful tools available than using aid to make projects viable. For example, opening our markets to exports would generate billions of dollars of new investment, without requiring public agencies to pick winners or set aside capital for guarantees.

In my view, OECD countries can do much more to boost private investment by improving their own policies: deploying better technology transfer and intellectual property regimes, opening their data, investing in research and development, reducing agricultural subsidies, tackling corruption and improving international tax co-operation. These policies, more than aid-financed subsidies, can drive truly transformational increases in investment, innovation and growth that will benefit rich and poor countries alike.
Mezzanine finance refers to the layer of financing between an institution’s senior debt and equity. It is often a more expensive financing source for a company than senior debt because in the event of default, the mezzanine financing is only repaid after all senior obligations have been satisfied. However, it is a less expensive alternative to equity, as mezzanine financing is repaid before direct equity investments are serviced.

Development co-operation agencies typically invest in the most risky (junior or first loss) tranche, while development finance institutions (the private sector arm of providers’ development co-operation) invest in the mezzanine tranche. Together they provide sufficient protection to attract additional private investment into the more senior tranches of the fund (Box 11.3).

Box 11.3. Mezzanine finance and renewable energy in Latin America

In Latin America and the Caribbean, a key barrier to affordable financing for renewable energy project developers and small businesses has been high collateral* and project equity requirements for bank loans. To address these barriers, and to mobilise commercial and development bank debt from both local and international sources, the recently established Central American Renewable Energy and Cleaner Production (CAREC) Facility provides innovative, “mezzanine” financing for renewable energy, energy efficiency and clean production projects in seven countries (Belize, Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua and Panama). Mezzanine financing serves as a bridge to help entrepreneurs access bank loans by, for example, offering unsecured loans or additional project equity. The fund’s USD 20 million capital will be used to co-finance energy projects with local banks, and is expected to leverage over USD 65 million in private investment for clean energy projects.

Several projects have already been financed through CAREC. In Guatemala, an investment of USD 2.5 million was approved in 2006 for Bioenergia, a company that recycles biogas from distilleries. In Honduras, two projects have been financed: a 13.5 megawatt (MW) hydroelectric plant to supply households and industries in Intibuca and a 9.5 MW private grid-connected hydroelectric plant. In Costa Rica, investment was approved in 2010 for a beef-rendering plant that uses bi-products to process meat and bone for animal consumption.

* In lending agreements, collateral is a borrower’s pledge of specific property to a lender to secure repayment of a loan.

Key recommendations

- Expand the use of different financial instruments beyond grants and concessional loans where market conditions allow (e.g. in productive sectors) to complement and save scarce concessional funds for interventions that do not generate (enough) financial returns to support the use of market-based instruments but require more concessional finance instead. These include investments in the social sector or in high-risk environments.

- Support policy reform to create a conducive business environment for public and private investment, including sound regulatory and legislative frameworks, reliable payment mechanisms, clear underlying tariffs and transparent bidding processes (the subject of Chapter 12). This will maximise the mobilisation potential of the instruments described in this chapter.
Notes

1. Concessional loans are provided at far lower than market rates for developing countries, for longer terms and with conditions which allow grace periods for payments.

2. The debt-to-equity ratio is calculated by dividing total liabilities by total equity. The debt-to-equity ratio is a financial leverage ratio. Financial leverage ratios are used to measure a company’s ability to handle its long-term and short-term obligations.

3. In this chapter, guarantee schemes refer to guarantees and insurance.

4. The amount mobilised by guarantees was defined as the face value of the loan for which a guarantee is issued.

5. Only institutions with a developmental mandate were included in the sample.

6. Equity is ownership interest in a company, represented by the shares issued to investors.

7. Equity funds invest in the equity of companies while debt funds provide debt instruments to their clients.

8. The company seeking investors.

References


