

# The Future of Private Finance for Development in Poor Countries

**Nancy Lee and Mauricio Cardenas G.**

## Abstract

This paper reviews data on private development finance flows in poor countries, identifies the lessons and questions that should shape future efforts to mobilize more finance, and develops proposals to strengthen performance. The data reveal a sobering picture. The vast majority of finance from development finance institutions (DFIs) goes to middle-income countries, including concessional finance as part of blended finance transactions. Global infrastructure transactions with private participation in poor countries are stuck below \$15 billion and show no upward trend. Foreign direct investment as a share of GDP is trending downward and private portfolio inflows remain negligible and volatile. With pandemic financing needs layered on top of huge financing gaps for the Sustainable Development Goals, the development finance architecture is just not mobilizing private investment in poor countries on the scale needed.

The evidence suggests several areas where DFIs, including multilateral development banks, and their shareholders should consider major changes to increase the scale of operations and effectiveness in poor countries. The paper offers five concrete proposals for change: (1) set targets for the shares of DFI commitments and concessional finance in poor countries; (2) change the DFI model to add a financial structure capable of managing more risk and making more projects bankable in poor countries; (3) mitigate, as well as share, risk through sectoral compacts that combine support for policy and institutional reforms with project finance (4) double down on building local capital markets, but target the most important gaps and (5) build green finance markets in poor countries through sovereign debt credit enhancements and technical assistance for local banks and bank regulators.

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## **The Future of Private Finance for Development in Poor Countries**

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## **Introduction**

From the beginning, the extent to which poor countries would share in, and benefit from, the 2015 “billions to trillions” vision<sup>1</sup> has been uncertain. Clearly, the need for private development finance is no less compelling in poor countries than in middle income countries. Tight fiscal constraints and high public debt burdens, limitations on growth in ODA and concessional lending, weak public sector capacity to deliver social and infrastructure services, the need for private sector innovations to solve production and distribution problems all point to the importance of the private sector role in poor country development. Yet it is undeniable that difficult investment environments in many poor countries stifle growth in the private finance sector and the private real sector. Even more than in other countries, it was clear that mobilizing private investment for development in poor countries was going to require significant public interventions to share and mitigate risk, including through policy, regulatory, and institutional reform.

Now, five years later, we can observe what has happened to private finance trends in poor countries. And we know that the global pandemic has layered massive countercyclical and social spending needs on top of yawning SDG finance gaps. It is time to take stock, assess where progress has been made and where it has not, and identify how to direct efforts more effectively going forward. This paper reviews the data on private development finance flows in poor countries, identifies the lessons and questions that should shape future efforts to mobilize more finance, and develops proposals to strengthen performance.

## **Landscape and trends**

There is no consistent, standardized way to measure either external or internal private development finance for poor countries. In concept, such finance encompasses all private investment that increases productive capacity, builds markets, reduces poverty, or accelerates growth--especially, but not only, in sectors that advance the Sustainable Development Goals. Yet it would be useful to review developments and trends in private finance from different sources, even without consistent definitions of which countries are poor and which private finance is funding development. This section describes private finance flows and finance to fund the private sector in poor countries from six sources<sup>2</sup>: development finance institutions, blended finance providers, impact investors, infrastructure finance providers, external private direct and portfolio investors, and internal private investors. Clearly the last two sources include investments not specifically related to development, but the data can give a sense of major changes in the importance of these private flows for funding investment generally in poor countries.

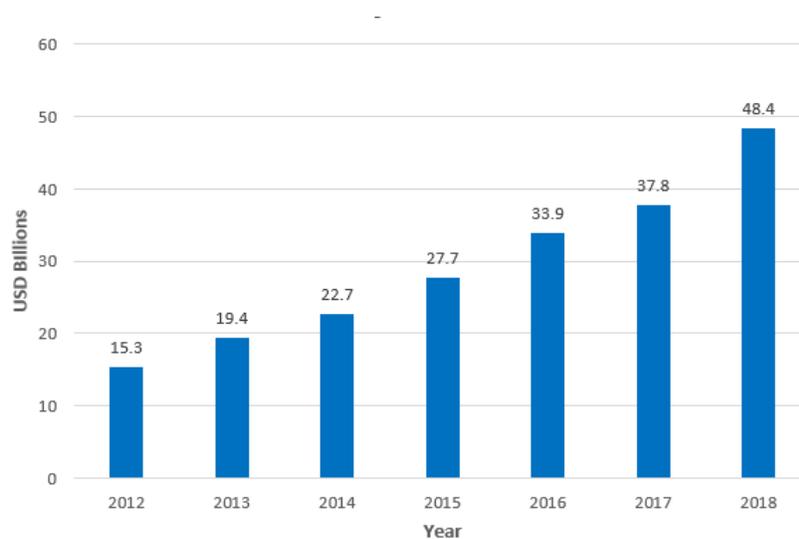
There is also no standard definition of poor countries. The World Bank, for example, uses one definition for low income countries (LICs)<sup>3</sup>, while the UN defines a different set of least developed countries (LDCs)<sup>4</sup>, and a third group composed of countries eligible for IDA concessional resources was designated by the G20 for its recent Debt Service Suspension Initiative.<sup>5</sup> In this paper, all three definitions will be used depending on the data source. Data for LDCs and IDA-eligible countries include some countries that the World Bank would

classify as lower middle-income countries (LMICs). Some data on finance flows are only available by recipient region, not by country income group. In that case, data will be reported for Sub-Saharan Africa, as the region with the largest number of poor countries.

## Development finance institutions

As part of its Development Assistance Committee (DAC) Statistics, the OECD reports on private finance mobilized by official (public) development finance institutions (DFIs). These institutions reporting to the DAC include more than 12 multilateral DFIs and more than 16 bilateral DFIs. The most recent report finds that these DFIs collectively mobilized a total of \$48.4 billion in private finance in 2018, as compared to \$37.8 billion in 2017.<sup>6</sup>

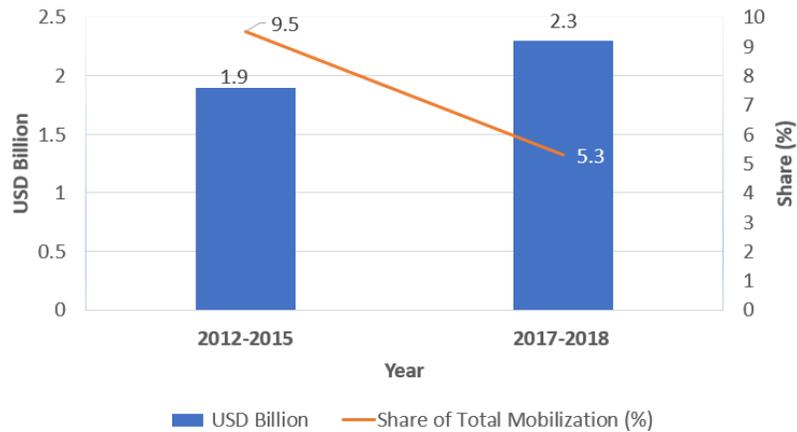
**Figure 1. Amounts of private finance mobilized by DFIs**



*Data source:* OECD, Amounts mobilized from the private sector by development finance interventions, February 2020.

Yet, of that total mobilization, only *5 percent* or an average of \$2.3 billion per year in 2017-18 went to LDCs and other LICs. For the period 2012-15, the LDC/LIC share was nearly 10 percent. The average annual amount mobilized for LDCs/LICs was about the same at \$1.9 billion per year in 2012-15, indicating that growth in mobilization for LDCs/LICs lagged growth in mobilization for MICs.

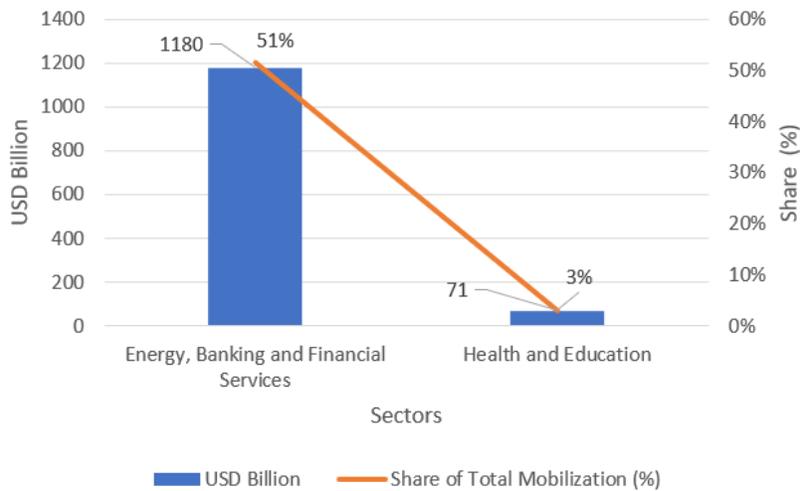
**Figure 2. Private finance mobilized by DFIs in LDCs and other LICs**



*Data source:* OECD, Amounts mobilized from the private sector by development finance interventions, July 2017 and February 2020.

Fifty-eight percent of mobilization for LDCs plus other LICs was through the DFI use of guarantees. Direct investment (both equity and debt) in companies took the next largest share, 16 percent. By sector, energy and financial services accounted for 51 percent of the mobilization in LICs, health and education only 3 percent.

**Figure 3. Private finance mobilized by DFIs in LICs, by sectors**



*Data source:* OECD, Amounts mobilized from the private sector by development finance interventions, February 2020.

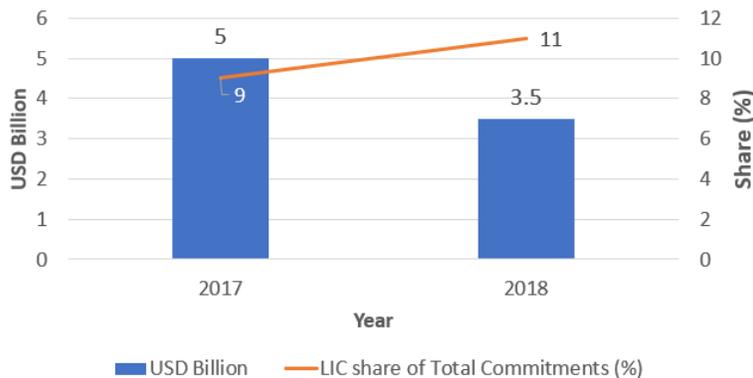
## Blended finance

Blended finance combines development finance provided on commercial (market) terms by public or private entities with finance provided on concessional (grant or below-market) terms by public (e.g., government donors) or private (e.g., foundations or philanthropic investors) entities. Because it offers the opportunity to use concessional finance to share and mitigate risks, blended finance is well adopted for addressing the challenges of investing in poor countries.

Multilateral and bilateral DFIs provide blended finance to the private sector in the form of commitments on their own balance sheets (“own-account commitments”), and through commitments of concessional finance made available to them by donors. The DFI Working Group reports annually on these blended finance commitments.<sup>7</sup> Note that blended finance represents a small share of overall DFI transaction value, about 6 percent: fully commercial operations (covered in the OECD DAC report described above) without any concessional component account for about 94 percent of annual project value.

For 2018, the latest year available, the blended finance commitments of the DFIs covered in the report to LICs and MICs (middle income countries) totaled \$3.5 billion--\$2.4 billion in DFI own-account commitments and \$1.1 billion in concessional commitments.<sup>8</sup> Of that, \$372 million or 11 percent went to LICs--\$203 million in concessional commitments and \$169 million in DFI own-account commitments.

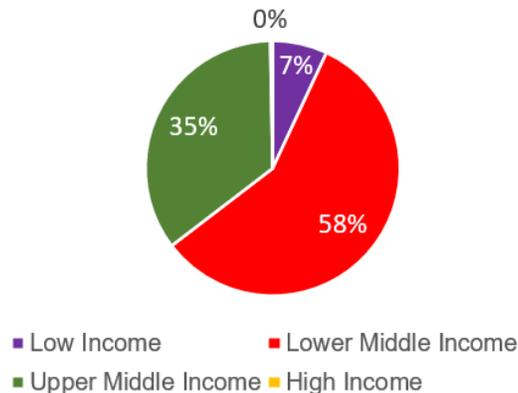
**Figure 4. Blended finance commitments by DFIs in LICs and MICs**



*Data source:* DFI Working Group on Blended Concessional Finance for Private Sector Projects, Joint Report, October 2019 and 2018 Updates

The LIC share of DFI own-account commitments, most of which go to LMICs and UMICs (lower and upper middle-income countries), was only 7 percent.

**Figure 5. Shares of DFI own-account commitments, 2018**

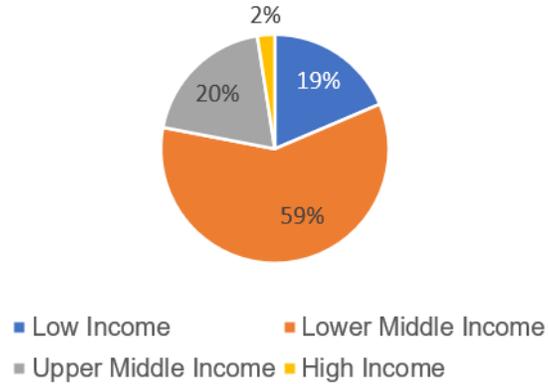


*Data source:* DFI Working Group on Blended Concessional Finance for Private Sector Projects, Joint Report, October 2018 Update

The LIC share of private finance mobilized by DFI blended finance transactions was 5 percent, no higher than the share mobilized by overall DFI operations in LICs. Each blended finance dollar DFIs committed to LICs in 2018 helped mobilize 0.44 dollars in private finance. DFIs cite the limited supply of investable projects in poor and small economies and high transaction costs to explain the low LIC share in their portfolios and in their mobilization of private finance. Notably, as a share of GDP, IFC’s investments in LICs are higher than those in MICs.<sup>9</sup>

What is perhaps more surprising is the low share of concessional commitments that go to LICs—\$202.5 million or 19 percent, roughly the same share as that received by UMICs (LMICs receive 59 percent). One might have expected that LICs would receive a larger share of concessional funds available in order to help make more projects bankable and help offset the effect of transactions costs on project returns.

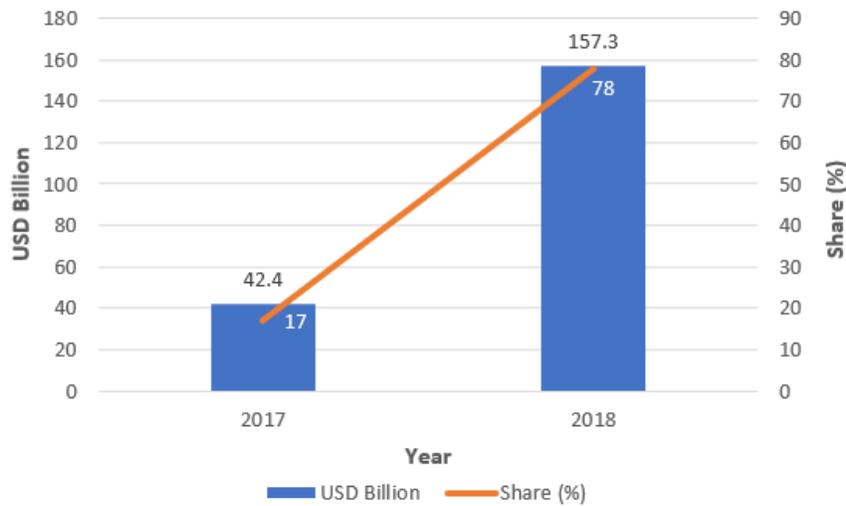
**Figure 6. Shares of DFI concessional commitments, 2018**



*Data source:* DFI Working Group on Blended Concessional Finance for Private Sector Projects, Joint Report, October 2018 Update

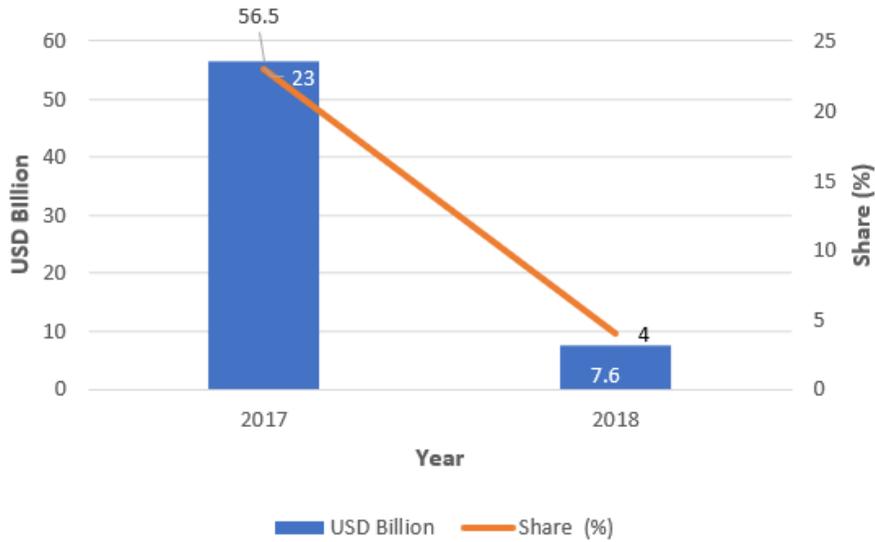
On a sectoral basis, in 2018, 78 percent of DFI blended finance projects in LICs were in the finance sector, while only 4 percent were in infrastructure. There is large year-to-year variation in sectoral shares, however: for 2017, the infrastructure share was considerably higher and the share of the finance sector smaller.

**Figure 7. DFI blended finance in LICs in the financial/banking sector**



*Data source:* DFI Working Group on Blended Concessional Finance for Private Sector Projects, Joint Report, October 2019 and 2018 Updates

**Figure 8. DFI blended finance in LICs in the infrastructure sector**



*Data source:* DFI Working Group on Blended Concessional Finance for Private Sector Projects, Joint Report, October 2019 and 2018 Updates

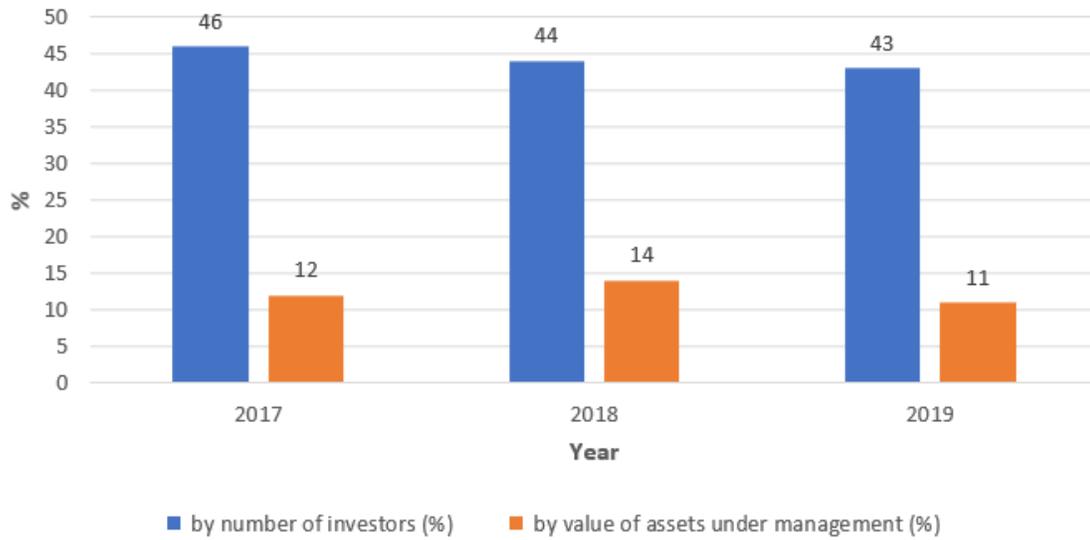
A recent OECD survey of blended finance facilities covers both private and public blended finance providers, not just DFIs.<sup>10</sup> That survey reports that at end-2017 LDCs accounted for \$7.6 billion invested in developing countries by blended finance providers, or 13 percent. About 8 percent of the commercial finance invested by blended finance providers went to LDCs.

### **Impact investment**

Impact investors, public and private, invest for financial returns as well as positive impact for development and for environmental, social, and governance gains. Relatively little information is available about levels and trends of impact investment specifically in poor countries. The most complete survey of impact investors is the Global Impact Investor Network (GIIN) annual survey.<sup>11</sup> The 2020 report shows that, for a sample of 289 impact investors with \$221 billion in assets under management, 47 percent of investors invested in the US and Canada. But the next largest percentage of investors, 43 percent, invested in Sub-Saharan Africa (SSA). So SSA clearly is a region of focus for impact investors as a group.

The picture is different, however, if the shares are calculated based on the value of assets under management (AUM). In that case, the US and Canada accounted for 30 percent of AUM, and SSA drops to fourth place at 11 percent, or \$24 billion. The data suggest that transactions in SSA were relatively numerous but small in value.

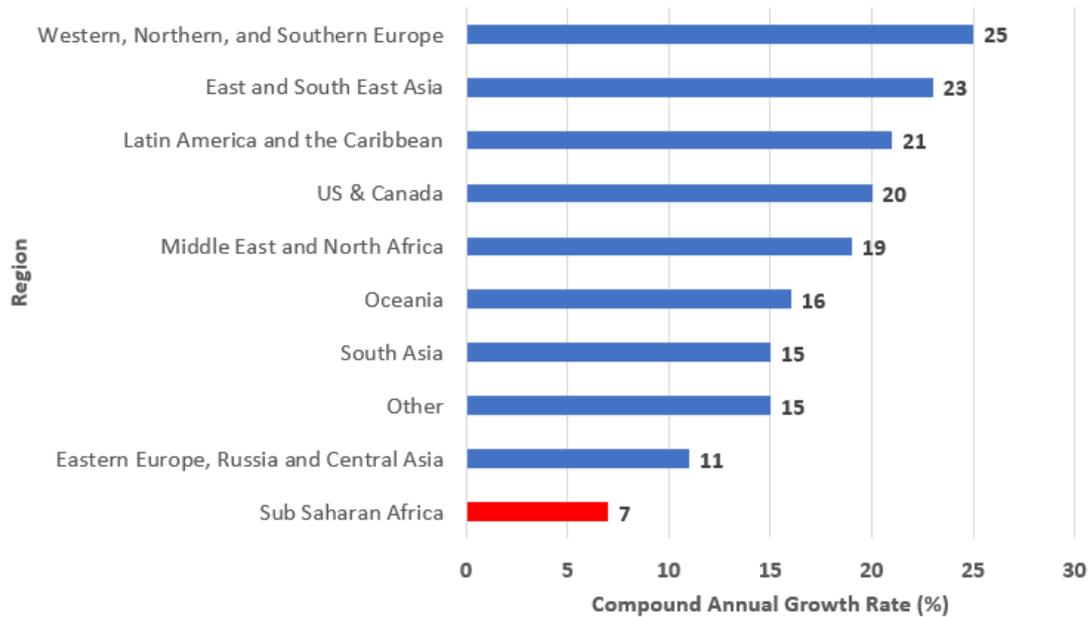
**Figure 9. Shares of impact investment in sub-Saharan Africa**



*Data source:* Global Impact Investing Network (GIIN). Annual Impact Investor Survey. 2018, 2019 and 2020.

Also telling are recent trends in compound rates of impact investment growth from 2015 to 2019. The growth rate for SSA was the smallest of any of the regions at 7 percent. Regions with the fastest compound growth rates were Western Europe, East and Southeast Asia, Latin America and the Caribbean, and the US and Canada, all of which grew by 20 percent or more.

**Figure 10. Compound rates of impact investment growth across regions, 2015-2019**



*Data source:* Global Impact Investing Network (GIIN). Annual Impact Investor Survey. 2020.

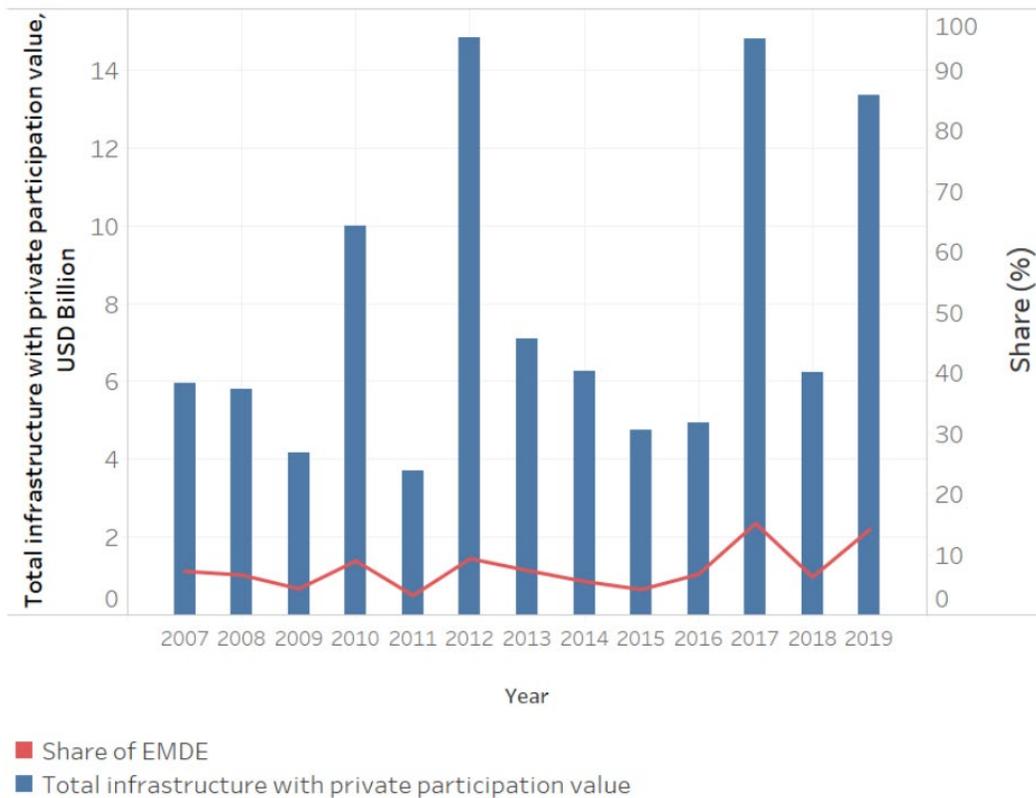
Going forward, impact investors surveyed were asked about their intentions for increasing allocations by region. The largest percentage, 52 percent, indicated that they intended to increase their investment allocations in SSA, the same percentage as for Southeast Asia. Clearly, many impact investors, at least prior to the pandemic, saw SSA as a region of opportunity to pursue their dual return/impact mandate.

### **Private infrastructure finance**

The World Bank Private Participation in Infrastructure (PPI) database tracks all infrastructure transactions in emerging markets and developing economies (EMDE) which include private finance as part of the project value. For the 74 countries eligible for IDA concessional resources (IDA countries and IDA blend countries), the data show low values of PPI finance and no trend: total transaction values for all IDA-eligible countries have ranged in the last five years (2015-2019) from \$4.75 billion in 2015 to \$14.8 billion in 2017.

Annual growth rates have varied widely from -24 percent in 2015 to +115 percent in 2019. The IDA-eligible countries' share of EMDE transactions has also fluctuated, from a low of 4.2 percent to a high of 15.1 percent over the period.

**Figure 11. PPI infrastructure transaction values and share of EMDE for IDA-eligible countries**

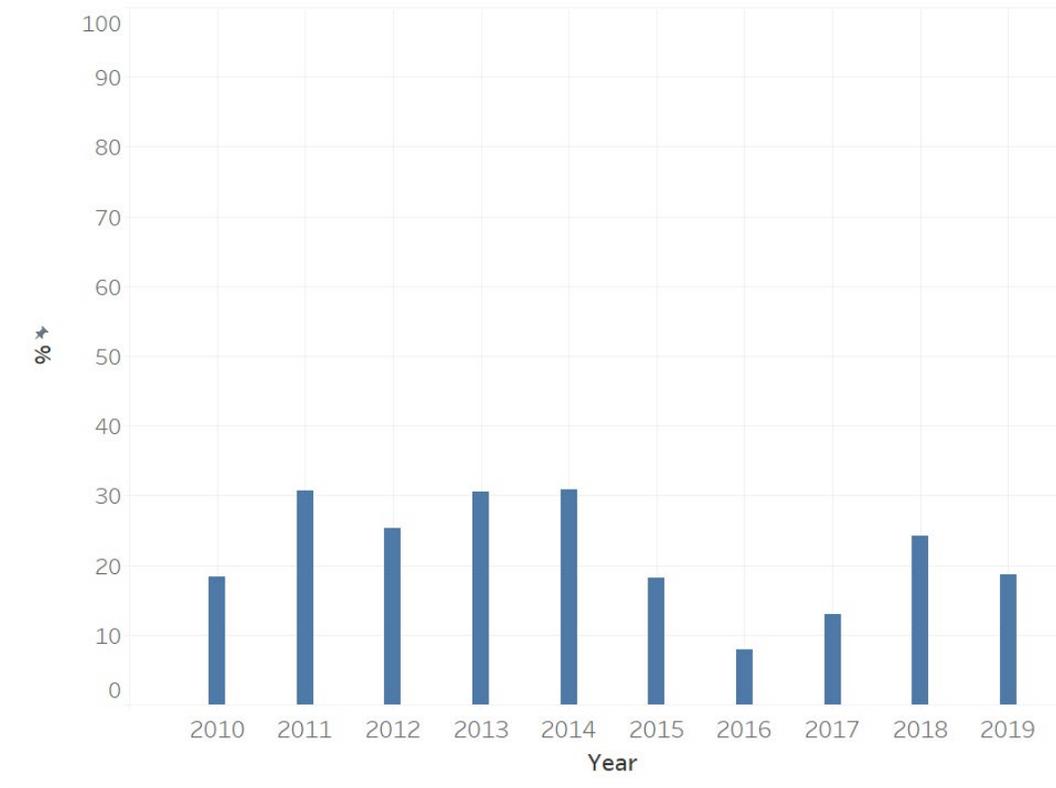


*Data source:* WB PPI database

Energy and transport have dominated PPI investment, taking 67 and 22 percent of the cumulative value respectively. Information and communications technology (ICT), water and sewage, and solid waste infrastructure together received a cumulative share of 10 percent. The role of multilateral DFIs in financing PPI transactions in poor countries has also fluctuated significantly, ranging from a low of 8 percent of PPI investment in 2016 to a high of 24 percent in 2018, with an average of 16 percent for 2015 to 2019.

The trend in the multilateral DFI share of PPI finance for poor countries appears to be broadly downward, with the average for the previous 5 years (2010-2014) at 27 percent.

**Figure 12. Multilateral share of PPI finance for IDA-eligible countries**



*Data source:* WB PPI database

Overall, we do not see evidence in the private infrastructure finance data for poor countries of a growing role for multilateral DFI finance in mobilizing private SDG-related investment. Low multilateral DFI shares of transaction values are not necessarily a bad outcome if the amount of private finance mobilized shows an upward trend. Unfortunately, that is not what we observe. Neither the total value of PPI investment for IDA-eligible countries nor the multilateral DFI finance share is increasing over time.

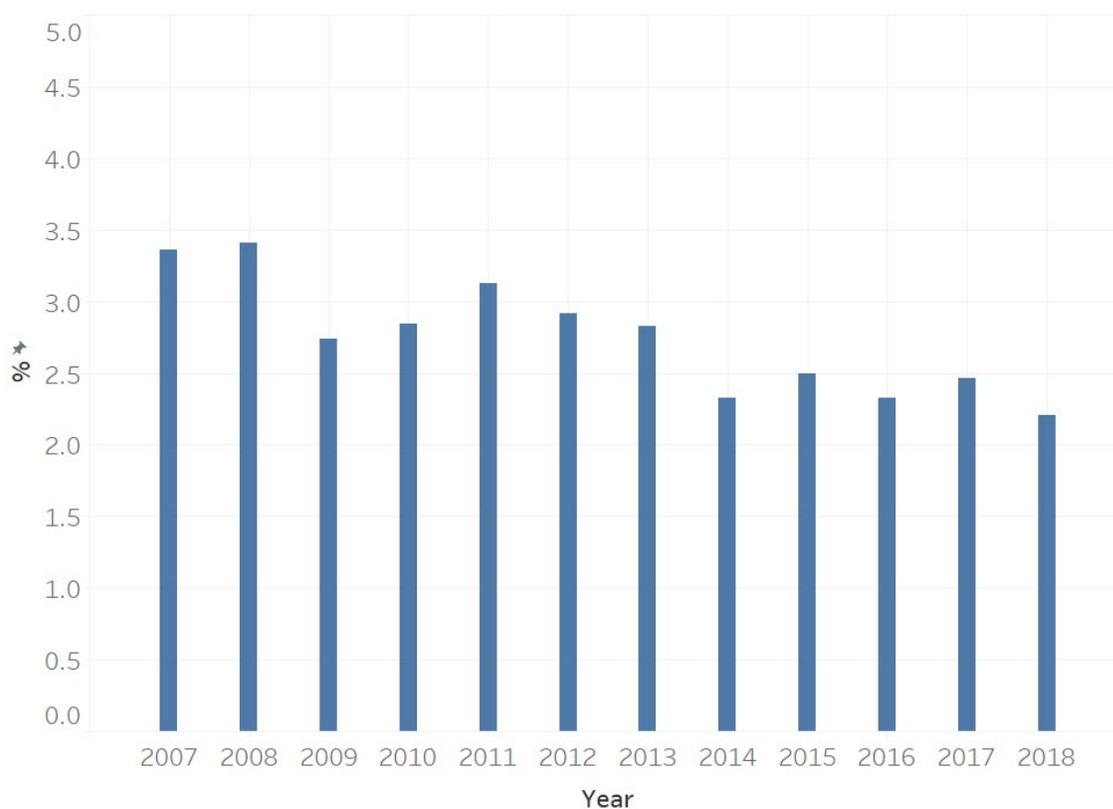
The bilateral DFI share of finance has shown some tendency to increase, with the average 2015-2019 share at 26 percent compared to the 2010-2014 average share at 18 percent. China's DFIs play a role in this increase, although the PPI data include China DFI finance values for only 7 projects in IDA-eligible countries from 2012 to 2019. China DFI finance is concentrated in fully public infrastructure finance transactions, with no private participation; therefore much of it falls outside the PPI database.

Private project sponsors supplying equity to the transaction are standard in PPI transactions for IDA-eligible countries, as they are for other countries. For the period 2015-2019, private commercial equity accounted for 84 to 100 percent of PPI investment equity. Private commercial debt made up from 13 to 36 percent of PPI investment debt over the period, fluctuating from year to year with no trend evident.

## External private capital inflows

Foreign direct investment as a share of GDP peaked in 2008 at 3.4 percent of GDP for IDA-eligible LICs as a group<sup>12</sup>. It dipped during the global financial crisis and has never recovered its pre-crisis share. In addition, its average share in 2014-2018 at 2.4 percent is below the 2009-2013 average of 2.9 percent. These developments are heavily influenced by commodity prices, which drive much of the FDI in many resource-dependent poor countries. Commodity price weakness in recent years has now been exacerbated by the global economic effects of the pandemic.

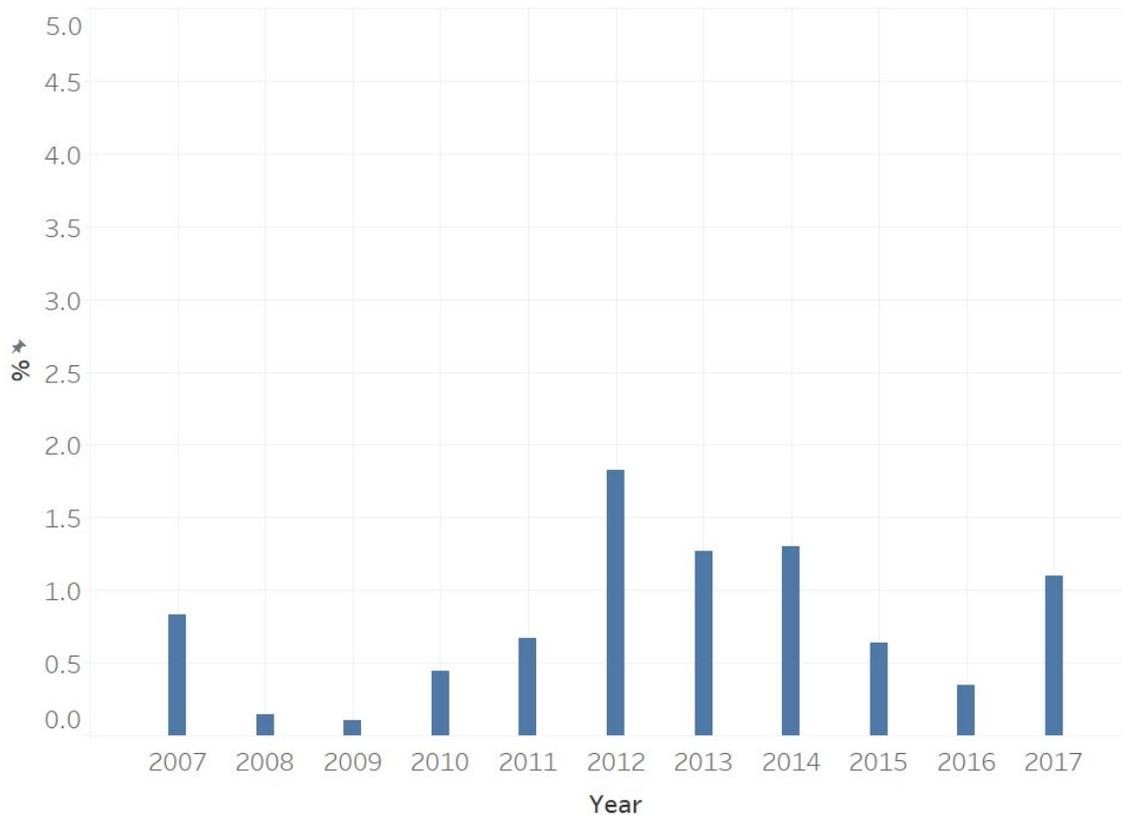
**Figure 13. FDI as a share of GDP for IDA-eligible countries**



*Data source: WB WDI Database*

Portfolio capital inflows into IDA-eligible LICs are relatively small and volatile, peaking at 1.8 percent of GDP in 2012 and falling sharply thereafter until 2017. (Data for the group are not available for more recent years.<sup>13</sup>) As for other countries, global growth and interest rates heavily influence these flows. The global search for yield could spur increased interest in relatively high-yield LIC bonds. But this could be more than offset by severe debt sustainability problems in LICs, forty percent of which were at or near debt distress even before the pandemic.

**Figure 14. Private portfolio capital inflows as a share of GDP for IDA-eligible countries**

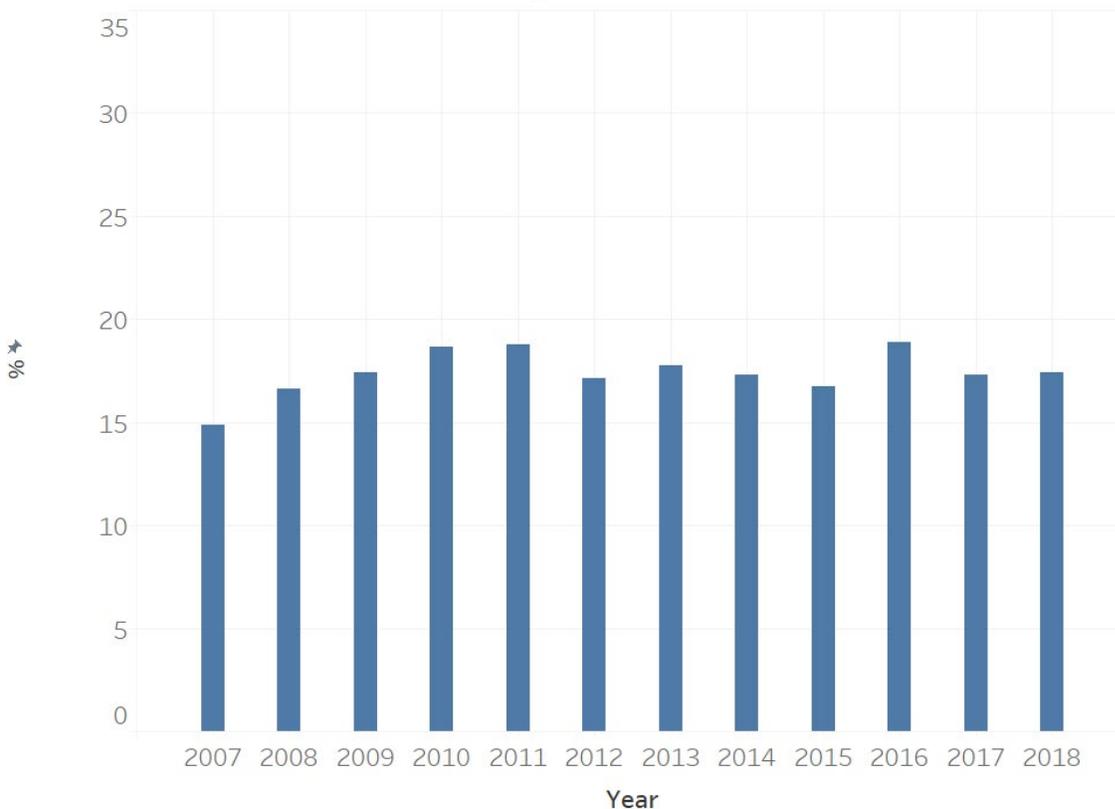


*Data source:* WB WDI Database and IMF BOPS

### **Domestic private investment**

As in other countries, domestic investment is the largest source of finance for promoting growth and development in LICs, much larger than external capital inflows and aid inflows. Domestic private capital formation in IDA-eligible LICs as a group<sup>14</sup> has ranged between 16.7 and 18.8 percent of GDP for the 10 years from 2009 to 2018. No trend up or down is evident. The share has been notably resilient to external shocks from the global finance crisis and commodity price slumps.

**Figure 15. Domestic private investment/GDP for IDA-eligible countries**



*Data source:* WB WDI Database

Research indicates that financial sector development and deepening is a key driver of domestic private investment. Domestic credit to the private sector as a percent of GDP has been rising in LDCs and other LICs but remains very low relative to that of MICs.<sup>15</sup> This evidence favors the large share of the financial sector in DFI operations in LICs, though it should be targeted in ways that increase development, environmental, and social benefits.

## **Lessons and challenges**

The data show a sobering overall picture: the “billions to trillions” vision has limited relevance for LICs. The latest data show that:

- The vast majority of DFI finance goes to MICs.
- Ninety-five percent of the private finance mobilized by DFIs goes to MICs.
- Health and education receive only 3 percent of the private finance mobilized by DFIs.

- Guarantees generated 58 percent of the private finance mobilized by DFIs in LICs, even though loans dominate DFI portfolios.
- Blended (commercial plus concessional) finance transactions are a minimal (6 percent) share of DFI transactions and 89 percent of it goes to MICs.
- Eighty percent of the concessional portion of DFI blended finance transactions goes to MICs.
- Infrastructure transactions with private participation (PPI infrastructure) for LICs (IDA eligible countries) have been stuck between \$5 and \$15 billion per year for the last 10 years, with no upward trend.
- ICT, water and sanitation, and solid waste infrastructure receive very little of this finance in LICs.
- No rising trend is evident either in the PPI infrastructure finance role of the multilateral DFIs or in their mobilization of private infrastructure finance.
- FDI as a share of GDP has fallen by about a percentage point in recent years from its peak of 3.1 percent in 2011.

Two additional aspects of this evidence are worth highlighting. First, concerns about a flood of concessional finance flowing out of transactions to finance governments and into unwarranted subsidies for the private sector appear greatly exaggerated. Compare total aid flows each year of about \$150 billion to the total value of concessional commitments to the private sector made by major DFIs in 2018 of slightly more than \$1 billion.

Second, if private impact investors are included in the mix, we see a significant share of impact investor transactions in regions with many poor countries like SSA, and more than half of impact investors intend to increase that share. This suggests that public-private partnerships could help pull public DFIs more in the direction of frontier markets.

Nevertheless, development finance flows to LIC private sectors are falling drastically short of needs and expectations. The development finance architecture is just not mobilizing private investment in poor countries on the scale needed. This is the time to reassess and adjust either the billions to trillions strategy, or the way the major development finance institutions operate, or both. Several core questions will have to be addressed:

- *Should DFIs as a group significantly increase the LIC share of their transactions?* DFIs argue that the small LIC share of DFI commitments reflects the limited size and opportunities of LIC economies. Yet the mission of DFIs is to mobilize finance in commercially viable transactions where market failures and gaps in capital markets prevent the private sector from doing so. Nowhere are such failures and gaps more evident than in LICs.

For this reason, shareholders generally view DFI operations in LICs as squarely meeting the important criterion of “additionality”, and they press for increased transactions in LICs. The IFC, for example, had to commit to increase the share of IDA countries and fragile and conflicted states to 40 percent of its portfolio by 2030 as part of its 2018 agreement with shareholders on a capital increase.

More broadly, in light of serious and likely prolonged LIC growth and fiscal constraints in the wake of the pandemic, neither LICs nor DFI shareholders can afford a marginal DFI role in mobilizing private finance as part of the recovery.

- *If so, is the current DFI model suited to this goal?* The very low LIC shares and values in the data suggest that DFIs face fundamental tensions between their operating/financial models and investment conditions in LICs. Despite their broad toolkits, DFIs, like their commercial counterparts, struggle to overcome market failures and finance gaps and find bankable deals. And both seek market risk-adjusted returns—not unreasonable given the interests of DFI shareholders in maintaining profitability and institutional ratings, but hard to reconcile with the additional costs and risks of LIC transactions.

For most multilateral DFIs, retained earnings are the most important source of finance for expanding DFI equity and therefore lending capacity. Shareholders prefer this route to expansion rather than frequent general capital increases, which are difficult, protracted, and politically sensitive processes for governments to manage.

Moreover, there is a mismatch between the most prevalent DFI financial instrument and skill mix and the instruments that are most catalytic. Lending dominates the operations of most DFIs, which contributes importantly to relatively low mobilization ratios. Loans averaged 85 percent of the financing commitments for the private sector of the five major multilateral DFIs in 2017.<sup>16</sup> Yet loans, especially senior loans, occupy the space of most interest to private commercial lenders. DFIs therefore face criticism for potentially crowding out, rather than crowding in, private finance. In fact, most of the mobilization of private finance by multilateral DFIs comes from other instruments, especially guarantees.

Loans also dominate DFI concessional finance commitments. The DFI Blended Finance Working Group reports that about 60 percent of DFI concessional commitment volumes are in the form of senior loans.<sup>17</sup> A shift in DFI instrument mixes toward guarantees and equity would likely increase mobilization ratios, but also likely increase risk and lower risk adjusted returns.

- *Should DFIs make greater use of blended finance transactions, particularly in LICs, in order to make more projects bankable? Would that be sufficient to significantly raise the LIC share of commitments?* Concentrating available concessional resources in LIC transactions could make a significant difference, but the data show that they are instead mostly deployed in MICs.

But the mere presence of concessional finance does not transform DFI cultures or make it easy for staff to find viable projects with high development impact. We have seen in the example of the IDA Private Sector Window<sup>18</sup>, which allocates \$2.5 billion in concessional finance for de-risking IFC projects in poor countries, that it has still proven difficult to ramp up IFC operations in IDA countries and fragile and conflict affected states.<sup>19</sup>

- *Is a DFI focus on increasing PPI infrastructure in LICs realistic? What would strengthen performance?* No sign of sustained growth in PPI infrastructure finance for LICs has emerged in the last decade. Infrastructure assets are in theory attractive for large global institutional investors, but they have very little appetite for emerging markets let alone LICs. For 2011 through mid-2017, institutional investors accounted for less than 1 percent of private finance for infrastructure projects in LICs and MICs.<sup>20</sup>

Institutional and other investors worry principally about political risk, regulatory risks, and risks associated with contract enforcement.

Multilateral DFIs have instruments to promote policy and institutional reforms that should be able to mitigate those risks effectively. But they struggle to bring these tools for engaging the public sector together with their project finance tools for the private sector.

These internal bureaucratic disconnects have high costs. Other evidence suggests that reforms in regulatory quality also have significant positive benefits for foreign direct investment in non-resource-rich LICs.<sup>21</sup>

Certainly the 2018 allocation of concessional commitments in DFI blended finance transactions in LICs did not prioritize infrastructure: only 3.5 percent (\$7.6 million) of concessional commitments went to infrastructure.

By sector, energy and transport dominate PPI finance for all EMDEs, not just LICs, accounting for 90 percent of all PPI finance in 2019.<sup>22</sup> Water and sanitation and municipal solid waste consistently receive very low amounts of PPI finance. Profitable investments are harder to find in these sectors: experience suggests that, as in other countries, LIC governments will have to fund infrastructure in these sectors.

## **Five proposals**

This evidence suggests a number of areas where DFIs and MDBs and their shareholders should consider major changes to increase the scale of operations and effectiveness in LICs. These changes would be challenging, risky, and would likely require some additional capital. Strong support from shareholders would be critical for success. But without change, the evidence offers little reason to conclude that DFIs are on track to substantially increase their role in private development finance for LICs.

### **1. Set targets for the shares of DFI commitments and concessional finance in poor countries.**

DFIs are investment opportunity driven. So they understandably resist targets for increasing commitments in the most difficult environments. But DFI performance so far, despite the shareholder push for more investment in LICs, strongly points to the need for targets to offset powerful internal forces and incentives arrayed against a large boost in LIC operations. The IFC and its shareholders have blazed the trail; other DFIs should follow.

At a minimum, it makes little sense to deploy 80 percent of scarce concessional finance in blended finance transactions in MICs. Concessional resources are critical for project development, technical assistance, and risk sharing in LICs. More broadly, shareholders should consider the merits of allocating a greater volume of concessional resources for mobilizing private finance, given that DFIs collectively used only about \$1 billion in concessional finance in blended finance transactions in 2018. But it would be hard to make a strong case for such an increase if it did not involve ambitious goals for private finance mobilized per dollar of concessional finance.

Different DFIs have different regions of operations, some with more LICs than others. So uniform targets across DFIs don't make sense. But it also follows that shareholders should consider the implications of increased LIC operations on capital and concessional resource adequacy in different regional DFIs.

### **2. Change (add to) the DFI model to manage increased risk and make more projects in LICs bankable.**

This analysis suggests that the deployment of blended finance must be accompanied by other changes in DFI operations in order to achieve scale in finance, impact, and mobilization in LICs. Chief among these are: (1) the ability to manage increased risk, (2) tolerance of lower risk-adjusted returns, (3) a change in the DFI mix of instruments, (4) greater emphasis on mobilization as distinct from volume of own-account operations, (5) a change in DFI cultures and staff incentives to place a higher priority on impact, and (6) a stronger capacity for innovation to build project pipelines that work in LICs and in serving poor and vulnerable populations.

These changes could be pursued by adding another financial structure to the DFI toolkit which would stretch DFI capital, take risk off-balance-sheet, make more projects bankable, and facilitate investment in LICs. One such proposal is the \$500 million *Stretch Fund*,<sup>23</sup> purpose-built to stretch the capital of existing DFIs in two ways: (1) expanding the spectrum of investments and environments in which DFIs can participate; and (2) taking on high-risk tranches to catalyze more private finance.<sup>24</sup> The Stretch Fund would look very different from existing DFIs, donor trust funds, or structured finance funds. It would:

- *Target a different financial goal.* The Stretch Fund would preserve capital at the portfolio level, cover its administrative costs, and not require regular replenishments. But its risk-adjusted returns at the portfolio level would be below-market or zero.
- *Deploy a flexible range of catalytic financial instruments to meet clients' needs and align staff skills with the instrument mix.* In contrast to the dominance of senior lending in existing DFI portfolios, the Stretch Fund would deploy mostly subordinated products: equity (including early stage equity and quasi-equity), guarantees and first loss protection, and subordinated debt, including in local currency.
- *Seek DFI deal proposals and originate innovative deals.* Most of the investment origination would come from DFIs interested in partnering with the Stretch Fund in order to access its risk-tolerant capital. But, unlike most donor trust and guarantee funds which operate as passive project takers, the Stretch Fund would also have the mandate to originate projects on the riskier, more innovative end of the spectrum. This is important for reaching investees that DFIs would normally not touch and for expanding the boundaries of market-making impact.
- *Increase mobilization ratios.* To play a meaningful role in mobilizing private finance for development, growth, and the SDGs, the Stretch Fund would aim to catalyze five dollars of finance from other investors for every dollar it commits.
- *Pool public and private capital.* The Stretch Fund would be a pooled investment vehicle, serving as a platform for aggregating capital from public and private investors that are like-minded in prioritizing development impact over returns, such as governments and risk-tolerant philanthropic and foundation investors.
- *Be a permanent capital vehicle.* The Stretch Fund would be a permanent capital vehicle with shareholder capital contributions in the form of equity. This would enable the fund to play the patient investor role that is so often missing and so critical to unlocking commercial finance.

### **3. Mitigate, as well as share, risk through sectoral compacts. Sharing risk is not the same as reducing it.**

DFIs can transfer some risk off the balance sheets of private partners by deploying guarantees and insurance and taking subordinated first loss and equity stakes. But such tools do not change the likelihood of losses or lower-than-expected returns, except insofar as DFI participation in transactions itself changes the behavior of governments and other actors.

What *can* reduce risk is better recipient country policies and stronger institutions in areas that have a direct impact on investment viability and performance. The public finance arms of multilateral development banks (MDBs) have the tools to help advance these reforms for

countries that have the political will. They can support for example: stronger public utilities, often essential partners in infrastructure transactions, that are solvent, meet obligations to suppliers, and better deliver, and collect fees for, services; independent competent regulatory institutions and tariff setting; property registries, credit bureaus, contract enforcement regimes; efficient, predictable business taxation systems; carbon taxes and reductions in subsidies for carbon-intensive production; especially in this time of COVID-19, financial support for MSMEs and for MSME lenders to help them survive until revenues begin to recover. MDBs can support such reforms and policies in LICs through concessional lending or technical assistance grants.

With limited exceptions, public and private finance transactions are separately conceived, designed, and negotiated by MDBs. It is time to bring them together in a common sectoral *compact* to exploit synergies and reap larger gains. Difficult reforms would look more attractive to governments if they see the direct benefits in terms of private investment, job creation, revenue generation, and poverty reduction. Risky investments would look more attractive to private investors if they see specific government actions that reduce risks and uncertainties for revenues, costs, and market growth. And the pandemic increases the need for, and urgency of, public private partnerships, especially using efficient private service delivery channels, e.g. mobile payment and credit services, to deliver government income transfer and MSME credit programs.

This approach would help private finance arms broaden their focus beyond individual transactions toward building markets with development impact. To the degree concessional finance is used, it would have wider benefits than just making individual transactions possible. And it would help the public finance arms identify and emphasize reforms that directly address the binding constraints to private investment in a specific sector and country.

Sectoral compacts would ideally be in the form of a single agreement between multiple MDBs, including both their public and private windows, and a government to avoid conflicting policy and private investment strategies being advanced by different MDBs. The government would agree to a set of policy and institutional reforms benefiting the sector (or sectors), and MDBs would agree to a certain envelope of sovereign lending (and/or grants) and help finance private investment transactions in that sector(s). The specific transactions would be added to the compact over time as they are approved and financed.

Variants of this kind of approach at the country level--combining support for reforms with project finance--can be found in the country compacts financed by the Millennium Challenge Corporation, Power Africa, World Bank country platform pilots<sup>25</sup>, and the G20 Compact with Africa (although this Compact offers private investors information about investment opportunities, rather than DFI project finance commitments).

#### **4. Double down on building local capital markets but target the most important gaps.**

DFIs are sometimes criticized for the large share of their operations channeled through financial intermediaries—e.g., banks and investment funds. The understandable concern is loss of control, transparency, and accountability for whether the finance ends up being used for the intended development purposes.

But the arguments in favor of using local financial institutions and funds, if done with robust results and impact measurement, are compelling. As noted above, evidence supports the hypothesis that strengthening local capital markets boosts domestic private investment. Using local intermediaries, as opposed to DFIs themselves, to find individual firms and transactions to finance is a better approach for scale and sustainability, especially if the transaction catalyzes more lending or investing beyond that financed by DFI resources. DFIs have an opportunity to target their finance to help fill critical capital market gaps that block firms from ever reaching the stage of access to the formal financial sector.

The problem is that DFIs typically are too risk averse to fill those gaps, for the same reasons as commercial actors. Capital market gaps found in many developing countries, and certainly in LICs, include:

- early stage equity—seed capital, angel networks, and venture capital;
- early stage finance for pre-operational infrastructure;
- finance in local currency;
- equity and liquidity for financial institutions serving missing middle firms, too large for microfinance but too small for the formal banking sector;
- equity and liquidity for commercial microfinance institutions seeking to become banks to better serve clients with growth potential;
- finance for women SME owners confronting large gender gaps in access to credit and equity;
- finance for private-sector-led innovations in health, education, and agriculture.

Regarding the last, we've seen that health and education account for a trivial share of DFI financial mobilization in LICs. The track record in renewable energy is much stronger. Yet we know that LIC governments do not and cannot offer adequate social services, especially to poor populations. We need the same tech and private innovation-driven reductions in cost and improvements in service quality in health and education that we've seen in the off-grid energy sector. While the public sector will provide the bulk of social services, it is a mistake to discount the private sector's potential in health and education, especially in LIC settings where governments' fiscal space and administrative capacity are tightly constrained.

DFI supported innovation is also needed in agriculture. Finance for smallholder farmers, farmer cooperatives, and the financial institutions and funds that serve them has long been the “un-cracked nut” of development finance. Yet such finance is critical for poverty reduction and food security, and is increasingly urgent to help rural populations adapt to the very real impact of climate change on productivity and sustainability. Innovation will be essential to solve problems of uncertainty, managing climate-change driven volatility in productivity and prices, market access, and information scarcity. Early stage finance, with all its risks, is essential for financing innovation.

Success in targeting these sectors and market gaps in LICs would require a concerted commitment by DFI management and shareholders to raise their priority, combined with the above-mentioned increases in concessional resources and off-balance sheet risk-management structures like the Stretch Fund.

## **5. Build green finance markets in poor countries through sovereign debt credit enhancements and technical assistance for local banks and bank regulators.**

If there is a silver lining to the serious and worsening sovereign debt sustainability challenges confronting many LICs, it may be the opportunity to use likely forthcoming restructurings to incentivize private sustainable investment. Restructurings often involve exchanges of existing debt for new debt with better terms for the debtor (lower interest rates, longer maturities, and even principal reductions). Bondholders may be attracted to the notion that fiscal savings under the restructured debt would be earmarked for SDG-related investment. In addition the MDBs could use their credit enhancement capabilities—guarantees and insurance—to incentivize bondholders to accept the new sustainable bonds as a safer asset than the old bonds.

Even for LICs not contemplating debt restructuring, this could be an attractive option given growing investor demand for sustainable bonds and pandemic driven increases in capital costs for many LICs. CGD Visiting Fellow Clemence Landers has advanced a proposal for IDA to issue partial risk guarantees on sovereign bonds or loans from commercial banks for the purpose of funding sustainable public investments while improving borrowing terms.<sup>26</sup>

In addition to sovereign issuances for green investment, LICs need private capital markets capable of offering green investment products. DFIs are seeking to develop EMDE markets for privately issued green bonds. Indeed, to date, most green bond issuance in emerging markets has been by financial institutions and corporates, not sovereigns.<sup>27</sup>

LICs generally have not issued green bonds. Green bond issuance by 5 countries in SSA totaled \$2.4 billion for 2012-2019 or 1 percent of the total for all EMDEs. Two of those, Kenya and Nigeria, are among the IDA-eligible group of countries.<sup>28</sup>

Realistically, green bonds are not likely to be a major source of climate finance in poor countries in the near term.<sup>29</sup> Those borrowing for green investments often need long-term

finance in local currency to provide time to capture the revenue streams and cost savings from transitioning to sustainable production technologies, products, and business models. But even in emerging markets, the majority of green bonds have tenors of only 3-5 years.<sup>30</sup>

Prospects are likely better for local banks as sources of green finance, given that LIC banking sectors are significantly more developed than corporate bond markets.<sup>31</sup> But current incentives for local banks to offer green finance are limited. DFIs lend to local banks to on-lend to clients for green investment. But they can also play an important role in creating the conditions that build markets for green finance in two ways<sup>32</sup>: (1) helping bank regulatory and supervisory authorities integrate climate change risks into their scrutiny of bank balance sheets, and (2) offering technical assistance to help banks develop commercially viable green products and services that meet the needs of small and medium firms, farmers, and vulnerable populations. This is another area where the public and private finance arms of MDBs will likely only achieve real scale and impact by working together, combining their regulatory reform, technical assistance, and project finance tools.

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- <sup>1</sup> <http://pubdocs.worldbank.org/en/622841485963735448/DC2015-0002-E-FinancingforDevelopment.pdf>
- <sup>2</sup> The six sources of development finance overlap significantly and therefore cannot be added together to construct an aggregate value.
- <sup>3</sup> The current number of LICs as defined by the World Bank stands at 29. The World Bank defines low-income countries as those having a Gross National Income (GNI) equal or less than US\$1,035 in 2019. The WB updates its income level classifications on July 1 every year and uses the World Bank Atlas Method. See <https://blogs.worldbank.org/opendata/new-world-bank-country-classifications-income-level-2020-2021#:~:text=not%20present%20%20%20%20Economy%20%20,%20%2011%2C240%20%203%20more%20rows%20>
- <sup>4</sup> The current number of Least Developed Countries (LDCs) as defined by the United Nations stands at 47. The United Nations defines the Least Developed Countries (LDCs) as low-income countries facing structural impediments to sustainable development. GNI per capita, Human Assets and Economic Vulnerability Indices (HAI and EVI, respectively) are used to determine whether a country falls into the LDC category. A country is classified into the LDC category if the country scores 36 points in the EVI, 60 points in the HAI, and the three-year average of the GNI per capita falls under the WB's low-income category. For further information, see <https://www.un.org/development/desa/dpad/least-developed-country-category/ldc-criteria.html> and <https://www.un.org/development/desa/dpad/least-developed-country-category/ldc-data-retrieval.html>
- <sup>5</sup> The DSSI Initiative includes 73 IDA-eligible countries plus other LDCs:  
<https://www.worldbank.org/en/topic/debt/brief/covid-19-debt-service-suspension-initiative>
- <sup>6</sup> <https://issuu.com/oecd.publishing/docs/amounts-mobilised-from-the-private-sector-by-dev-fi>
- <sup>7</sup> The DFI Working Group is composed of the AfDB, AsDB, AIIB, EBRD, EDFI, EIB, IDB Invest, Islamic Corporation for the Development of the Private Sector (ICD), and IFC.
- <sup>8</sup> [https://assets.ctfassets.net/4cgqlwde6qy0/6Z01w7djCGBzqUxozZm0GB/97b0ca6e692043125683791db0606f60/IFC\\_DFI\\_Blended\\_Concessional\\_Finance\\_Working\\_Group\\_Joint\\_Report\\_2019.pdf](https://assets.ctfassets.net/4cgqlwde6qy0/6Z01w7djCGBzqUxozZm0GB/97b0ca6e692043125683791db0606f60/IFC_DFI_Blended_Concessional_Finance_Working_Group_Joint_Report_2019.pdf)
- <sup>9</sup> <https://documents.worldbank.org/en/publication/documents-reports/documentdetail/171981598466193496/long-run-returns-to-impact-investing-in-emerging-market-and-developing-economies>
- <sup>10</sup> [https://assets.ctfassets.net/4cgqlwde6qy0/16givPvUXvSB6SBfkyEHnI/a36086154f4d22644f8cf0f905b474b8/OECD\\_Blended\\_Funds\\_Facilities\\_Survey\\_2019.pdf](https://assets.ctfassets.net/4cgqlwde6qy0/16givPvUXvSB6SBfkyEHnI/a36086154f4d22644f8cf0f905b474b8/OECD_Blended_Funds_Facilities_Survey_2019.pdf)
- <sup>11</sup> <https://thegiin.org/assets/GIIN%20Annual%20Impact%20Investor%20Survey%202020.pdf>
- <sup>12</sup> 69 countries were used in the sample (54 IDA and 15 IDA Blend Countries). Observations for countries whose data were missing and/or not consistent throughout the full range of years were excluded. Therefore, 5 IDA countries were excluded: Micronesia, South Sudan, Eritrea, Somalia, Syria.
- <sup>13</sup> 23 countries were used in the sample (15 IDA and 8 IDA Blend Countries). Observations for countries whose data were missing and/or not consistent throughout the full range of years were excluded.
- <sup>14</sup> 26 countries were used in the sample (22 IDA and 4 IDA Blend Countries). Observations for countries whose data were missing and/or not consistent throughout the full range of years were excluded.

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- <sup>15</sup> <https://www.oecd-ilibrary.org/docserver/9789264307995-en.pdf?expires=1598378552&id=id&accname=guest&checksum=56C86274E55ABF8AA11DFBC3DF47A644>
- <sup>16</sup> <https://www.cgdev.org/blog/still-lending-mostly-after-all-these-years>
- <sup>17</sup> [https://assets.ctfassets.net/4cgqlwde6qy0/6Z01w7djCGBzqUxozZm0GB/97b0ca6e692043125683791db0606f60/IFC\\_DFI\\_Blended\\_Concessional\\_Finance\\_Working\\_Group\\_Joint\\_Report\\_2019.pdf](https://assets.ctfassets.net/4cgqlwde6qy0/6Z01w7djCGBzqUxozZm0GB/97b0ca6e692043125683791db0606f60/IFC_DFI_Blended_Concessional_Finance_Working_Group_Joint_Report_2019.pdf)
- <sup>18</sup> <https://ida.worldbank.org/financing/ida18-private-sector-window>
- <sup>19</sup> <https://www.cgdev.org/blog/making-international-finance-corporation-relevant>
- <sup>20</sup> <https://www.institutionalinvestor.com/article/b17c778d90by4k/institutional-investors-mostly-absent-from-emerging-markets-infrastructure-projects#:~:text=According%20to%20the%20World%20Bank%2C%20institutional%20investor%20have%20been%20discouraged,with%20investing%20in%20developing%20countries.>
- <sup>21</sup> <https://www.cgdev.org/sites/default/files/trends-private-capital-flows-low-income-countries-good-and-not-so-good-news.pdf>
- <sup>22</sup> <https://ppi.worldbank.org/content/dam/PPI/documents/private-participation-infrastructure-annual-2019-report.pdf>
- <sup>23</sup> <https://www.cgdev.org/sites/default/files/Lee-Preston-Stretch-Fund-Full.pdf>
- <sup>24</sup> <https://www.cgdev.org/sites/default/files/Lee-Preston-Stretch-Fund-Full.pdf>
- <sup>25</sup> <https://www.cgdev.org/event/conversation-david-malpass>
- <sup>26</sup> <https://www.cgdev.org/blog/addressing-private-sector-debt-through-sustainable-bond-guarantees>
- <sup>27</sup> <https://www.ifc.org/wps/wcm/connect/a64560ef-b074-4a53-8173-f678ccb4f9cd/202005-EM-Green-Bonds-Report-2019.pdf?MOD=AJPERES&CVID=n7Gtahg>
- <sup>28</sup> <https://www.ifc.org/wps/wcm/connect/a64560ef-b074-4a53-8173-f678ccb4f9cd/202005-EM-Green-Bonds-Report-2019.pdf?MOD=AJPERES&CVID=n7Gtahg>
- <sup>29</sup> <https://www.cgdev.org/blog/paving-way-green-investment-emerging-market-and-developing-economies>
- <sup>30</sup> <https://www.ifc.org/wps/wcm/connect/a64560ef-b074-4a53-8173-f678ccb4f9cd/202005-EM-Green-Bonds-Report-2019.pdf?MOD=AJPERES&CVID=n7Gtahg>
- <sup>31</sup> <https://www.cgdev.org/sites/default/files/PP182-Lehmann-Private-Sector-Climate-Finance.pdf>
- <sup>32</sup> <https://www.cgdev.org/sites/default/files/PP182-Lehmann-Private-Sector-Climate-Finance.pdf>