CGD BRIEF
APR 2018

More Mobilizing, Less Lending

A Pragmatic Proposal for MDBs

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KEY TAKEAWAYS

- MDB private sector operations or windows (PSWs) are essential actors in mobilizing private finance for development, but their mobilization track record to date falls far short of a meaningful contribution to annual SDG financing gaps in the trillions.
- PSWs must evolve from lenders to mobilizers, but change is impeded by mixed shareholder messages and financial models that favor market returns for their own account.
- This paper proposes adaptation of the financial model to facilitate more risk tolerance, increased mobilization of private finance, and greater development impact.
- The proposal is to add and capitalize special purpose vehicles (SPVs) to PSWs that are designed to target highly catalytic uses—such as early stage finance and high-risk project tranches—while maintaining overall PSW ratings, financial sustainability, and returns.
- These SPVs could be capitalized from both public and private sources (e.g., foundations). Instead of creating one SPV for every MDB, a single SPV could serve multiple MDBs.
- MDB shareholders would benefit from: the limited new capital needed; the opportunity to create a new purpose-built, more effective SPV governance structure; creation of stronger incentives for cross-MDB collaboration; and linking their new capital to better institutional performance on innovation, mobilization, and development impact.

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THE NATURE OF THE CHALLENGE

Much is expected of the multilateral development banks (MDBs) as the international community confronts the daunting challenge of financing the Sustainable Development Goals (SDGs). The MDBs, especially their private sector windows (PSWs), are rightly regarded as essential actors in the challenge of moving from billions to the trillions of dollars of private finance necessary to fill yawning SDG finance gaps. These institutions—the original impact investors—have an array of tools needed to address the many obstacles that block the flow of private finance for development. PSWs are also good investments for their shareholders, as they are broadly sustainable, and they multiply and leverage the capital contributions of member countries.

Yet we observe a marked disconnect between these aspirations and actual outcomes for mobilization of private finance by PSWs. A 2018 report[1] puts 2016 mobilization ratios for MDB PSWs[2] at 1:1.5 for total *direct and indirect* mobilization: that is, for every $1 of PSW resources, $1.5 of private finance is mobilized. The *direct* mobilization ratio is 1:0.4: $1 of PSW resources mobilizes 40 cents of private finance.[3] The magnitude of annual private financing mobilized directly and indirectly by MDB PSWs, at about $60 billion, falls far short of a meaningful contribution to addressing annual SDG financing gaps in the trillions.

How can mobilization ratios be raised? The first step is clarity on the nature of the problem. Current mobilization ratios reflect PSW business models and internal incentives that favor profitable lending and investment for their own account. PSW shareholders expect market returns, maintenance of AAA institutional ratings, achievement of institutional profit objectives (in some cases for partial transfer to other parts of bank groups), and avoidance of subsidies that either distort markets or transfer risks to the public sector that belong with the private sector. This set of objectives, in practice, understandably constrains the risk tolerance of PSWs.

Conventional capital increases for PSWs would not address the business model problem. The absolute volume of private finance mobilized would increase, but a significant improvement in mobilization ratios is unlikely. Expanding PSW business as usual will not suffice.

Instead, PSWs should be provided scope to take more risk, substantially increase their operations in difficult countries and sectors, and target key gaps in capital markets that block the flow of private finance.

Two pervasive gaps play a central role in impeding the mobilization of private finance in developing countries. Enhancing the ability of PSWs to fill these gaps would do much to strengthen both their mobilization and development impact.

1. The scarcity of investors willing to take on the riskiest project tranches, such as first loss or junior equity and debt

2. Very limited early stage finance—for early stage firms, early stages of local capital market development, and pre-operational greenfield infrastructure projects

Both of these gaps are particularly acute in small, poor, or fragile markets where transaction costs are high relative to the potential size of investments.

A PROPOSAL FOR CAPITALIZING SPECIAL VEHICLES WITHIN PSWS

Adding special purpose vehicles (SPVs) with separate balance sheets to PSWs—purpose built for taking on additional risk—would help target these gaps while maintaining the AAA rating and profitability of core PSW balance sheets. These SPVs would not be expected to achieve market returns. In fact, their financial goal could be

1 Blended Finance Taskforce, "Consultation Paper: Better Finance Better World," 2018, http://businesscommission.org/our-work/new-consultation-paper-better-finance-better-world.

2 International Finance Corporation, Multilateral Investment Guarantee Agency, European Bank for Reconstruction and Development, European Investment Bank, IDB Invest, Asian Development Bank, African Development Bank, and Asian Infrastructure Investment Bank.

3 Direct mobilization is defined in the report as financing from a private entity on commercial terms due to the active and direct involvement of an MDB leading to commitment of private finance. Indirect mobilization is defined as finance from private entities provided in connection with a specific activity for which an MDB is providing financing, where no MDB is playing an active or direct role that leads to the commitment of private finance.

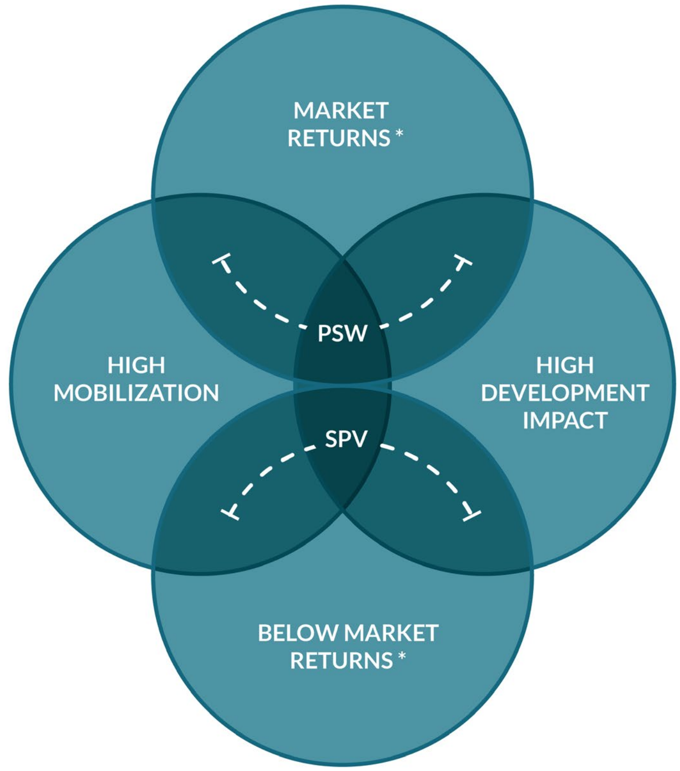
defined simply as preserving shareholder equity in real terms at the entity level.

The introduction of these SPVs would make the establishment of targets for higher mobilization ratios more reasonable and achievable. They would focus on the two capital market gaps identified above. The first—increasing the amount of finance for high-risk tranches of projects—would likely deliver an early boost to mobilization ratios, especially in middle-income countries. The second—more early-stage finance—should increase mobilization ratios over time by building stronger bankable project pipelines, both for private investors and for operations on the core balance sheet of the PSW. The SPV toolkit would be comprised principally of equity, quasi-equity, first-loss guarantees, junior debt, outcomes payments, and grants (including reimbursable grants). Grants would help address pipeline problems in high-risk sectors and countries through support for project preparation, product or business model innovation, and seeding startups. Outcomes payments would incentivize private investment in activities with high development impact by increasing or securing returns.

The basic idea is for the two parts of the PSW—the SPV and core operations—to offer a seamless continuum of products and services to clients. In some cases, this would make deals bankable that otherwise would not pass credit committees. In others, it would make scale and much larger deals possible. And in still others, it would mean a smooth handoff from the SPV to the core PSW operations when clients or markets are ready for commercial finance and growth. A critical additional success factor would be the extent to which the two parts of the PSW would be able to rely on the strong support of the MDB sovereign lending side—for promoting well-targeted policy and institutional reforms that make projects financially viable and for helping to finance the public share of public-private partnerships.

Capitalizing such SPVs offers certain attractive features to MDB/PSW shareholders. The amounts of capital needed would be relatively small, as the amount of finance needed for risky tranches and for early-stage capital is small relative to senior and growth capital needs. Moreover, because they would be new entities, the SPV shareholder structure and governance arrangements could be established *de novo*, avoiding concerns about dilution from countries that do not wish to participate. (The SPV would be governed by its own executive board of participating shareholders.)

MDB Private Sector Window with Special Purpose Vehicle



* RISK-ADJUSTED

PROJECT VERSUS PORTFOLIO RISK SHARING

Project origination would still largely be done by the core PSWs. When SPV funding is involved, the core PSW would propose projects to the SPV for approval by its board. But prior to board consideration, core PSW and SPV staffs and management would have worked closely together to ensure that standards are met both for commercial viability and for responsible use of blended finance.

It would be desirable, however, to include within the SPV a small team operating as a channel for innovative business models, technologies, and financing structures. In cases where market testing and adaptation is needed to establish commercial potential, these projects could be piloted by the SPV for later scaling in collaboration with the core PSW. This internal laboratory would be important to secure a steady flow of new ideas, strengthen a culture of openness to innovation, and push out the risk tolerance frontier within the PSW as a whole.

Another possibility is to take a portfolio, rather than project-by-project, approach to collaboration between the core PSW and the SPV. The SPV could take on a defined high-risk tranche of the portfolio or could guarantee part of the portfolio. This would have the advantage of simplicity and of stretching core PSW capital. But it would not necessarily change staff behavior, risk tolerance, and therefore mobilization at the project level. Instead, the outcome might be similar to that resulting from a conventional capital increase—more business as usual.

HOW DOES THIS PROPOSAL DIFFER FROM EXISTING SPECIAL PURPOSE VEHICLES?

Currently, PSWs usually raise bespoke risk-sharing funds from individual donors, which, while useful to pioneer innovative financial structures, are often limited with respect to sectors and financial instruments.[4] An exception is the new $2.5 billion IDA Private Sector Window, which is an IFC-managed SPV with broad-based donor support and flexibility regarding both sectors and blended finance tools. While the IDA PSW is a major step forward in incentivizing private sector operations in IDA countries, this SPV proposal has some important operational, financial, and governance advantages:

1. It would address critical capital market gaps and take on more risk in middle-income countries (MICs) as well as in low-income countries (LICs). Even with improved capital market access, MICs continue to face major challenges in mobilizing private finance for sectors that are high risk but critical for growth, especially inclusive growth. Addressing these gaps would promote poverty reduction in MICs and positive growth spillovers for LICs in their regions.

2. Retaining a focus on MICs as well as LICs would serve the key goal of a substantial improvement in mobilization ratios, especially in the short term.

3. Diversified operations across MICs and LICs would make SPV risk management easier.

4. The resources funding the SPV would take the form of shareholder capital rather than one-time donor contributions. This financing model would establish a basis for periodic assessments of SPV capital adequacy and possible capital increases, as in the case of PSW core capital.

5. An SPV capitalization of this nature in the IFC case would reduce future reliance on scarce IDA replenishment resources for private sector operations in IDA countries. Public investment needs in IDA countries are massive—for infrastructure and for the social sectors. Many would argue for considerable caution in diverting resources from public to private operations.

6. Under this proposal, shareholders would have the chance to create a new, fit-for-purpose governance mechanism to assess SPV performance at the portfolio level against agreed criteria for risk tolerance, returns, and development impact.

7. And finally, shareholders would be deploying their new capital in a way that incentivizes and facilitates the institutional change they seek--more openness to innovation and a greater focus on areas and projects with greater development impact.

TWO ADDITIONAL SPV VARIANTS WORTH EXPLORING

One SPV for all. A question of practical significance is whether it is necessary or desirable to contemplate creation of an SPV in each of the MDBs. The heavy lift of creating a new entity at each institution with its own governance structure, as well as the combined multi-institution capitalization demands and negotiations, would burden both shareholders and MDB managers.

4 An example is the Swedish International Development Cooperation Agency's partial first-loss guarantee for investors in the IFC's Managed Co-Lending Portfolio Program (MCPP) for infrastructure.

Creating one SPV that all MDBs could access would avoid this complexity. It would also facilitate collaboration across the MDB PSWs with the SPV as a common focal point. MDB PSWs could be incentivized to collaborate in order to access valuable SPV risk-sharing resources. At the same time and perhaps paradoxically, the SPV could generate healthy competition among the MDBs because the SPV management and board would have the opportunity to compare project proposals from a number of MDBs and select the best. In addition, the SPV could develop a diversified global portfolio which would help in managing risk.

The notion of establishing only one SPV raises the issue of where to put it. If the idea is to avoid establishing a new institution with the associated administrative fixed costs, it would make sense to place the SPV inside an existing institution. One possibility is the World Bank Group, which has a global mandate. But careful attention would have to be given to governance and decision-making arrangements to ensure equal access to the SPV for all MDBs and no favored status for the IFC.

A public-private SPV. Another option with distinct advantages is an entity capitalized with both public and private capital. This would reverse the usual PSW approach to crowding in private finance—which tends to reserve the lower risk tranches for private investors. Risk tolerant impact investors and philanthropists would instead be given a chance to participate in the riskier tranches where mobilization ratios and development impact are the highest. As a result, public shareholders would not have to bear the whole burden of capitalizing the SPV and would likely benefit from innovations and efficiency gains introduced by private impact investors. For their part, private investors would benefit from MDB pipelines, institutional standards, knowledge, presence on the ground, and the opportunity for greater scale. This structure would give private sector actors, as shareholders, a seat at the governance table—not such a radical idea in a world where public-private partnerships are increasingly regarded as central to development progress.

At least two possible concerns are worth exploring. First, the scale of funds potentially available from risk-tolerant impact investors and philanthropists is unclear. The bulk of impact investors and impact investor funds indicate that they seek market returns. Investments that target below-market returns but more development impact and mobilization potential—such as mission-related or programmatic investment—currently account for a small share (an estimated 2 percent) of private foundation endowments. But there are strong arguments favoring an increase in that share given the high mobilization potential of this risk-tolerant finance.[5] Second, the question of how much private investors would value a governance role inside an MDB is largely untested.[6] Would investors prefer to continue to invest alongside PSW investments and not put their funds in the vehicle, or would they be attracted to a role that gives them an opportunity to help shape PSW strategies and project choices?

A VIRTUOUS CIRCLE

By expanding bankable project pipelines and opportunities for scale for core PSW operations, these SPVs could well contribute to increased PSW profits. Over time, a portion of these profits could be used to add to the capital of the SPVs, increasing their scope for high-development-impact operations and reinforcing their sustainability. It is thus not unreasonable to anticipate the emergence of a positive feedback loop between the SPV and core PSW operations, benefitting overall financial performance, mobilization, and development impact.

5 Richard Henriques, Arjun Nath, Carra Cote-Ackah and Katherina Rosqueta, "Program-Related Investments: Is there a Bigger Opportunity for Mission Investing by Private Foundations?" The Center for High Impact Philanthropy at the University of Pennsylvania, 2016, https://www.impact.upenn.edu/wp-content/uploads/2016/04/160415PRIFINALAH-print.pdf.

6 Exceptions are the Dutch development bank, FMO, and the European Investment Fund (for SME finance), which are capitalized with both public and private funds.

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