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ENGAGING THE PRIVATE SECTOR FOR DEVELOPMENT: THE ROLE OF DEVELOPMENT FINANCE INSTITUTIONS?

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INTRODUCTION

The landscape of development finance has changed substantially over the last decade. First, aid budgets are being squeezed by most donors. In 2011 Official Development Assistance (ODA) from EU Member States fell for the first time since 2007 from 0.44 % to 0.42 % of GNI (gross national income). This percentage lies far from the UN target of 0.7 %. Second, private capital flows to developing countries have recovered substantially since their collapse in 2007. While they are still below pre-crises levels, private flows are steadily rising.[1] Third, public development finance is increasingly channelled towards the private sector.

Donor governments and multilateral institutions have provided grants and loans to private companies operating in developing countries for decades. However, the scale of this support has increased dramatically in recent years and new forms of private sector support have been developed.

Private capital flows increasingly receive public backing, such as in form of public loans to private investors, co-investments or guarantees. While support of the public sector has stagnated or decreased[2], the share of official development finance channelled to the private sector and financial infrastructure has steadily increased and representatives from aid agencies predict that this trend will accelerate (see the article of Kindornay/Reilly-King in this publication).

The Eurodad report 'Private profit for public good?' (Kwakkenbos 2012), assesses the portfolios of some of the largest multilateral and bilateral development agencies providing public support for the private sector in developing countries. Among them is the World Bank International Finance Corporation (IFC), external lending of the European Investment Bank (EIB), and six bilateral DFIs from Denmark, Belgium, the Netherlands, Norway, Spain and Sweden. Based on the findings of the report, this article provides first an overview over this new trend and further examines whether public development finance for the private sector in the South lives up to its promises to provide additional finance for socially desirable investments and to deliver positive development outcomes.

INTERNATIONAL PUBLIC SUPPORT TO THE PRIVATE SECTOR INVESTING IN THE SOUTH[3]

Since the 1990s, the scale of private sector support from bilateral and multilateral donors has dramatically increased. Multilateral Development Banks' lending and investment to the private sector went up from just over USD 5 billion in the year 2000 to over USD 40 billion in 2010 (IFC 2011) and is expected to exceed USD 100 billion by 2015 – making up almost one third of external public finance to developing countries.

Although a thriving private sector that contributes to equitable development requires public sector financial and non-financial support, Eurodad findings raise serious concerns that the balance between private and public sector investments in development finance is becoming increasingly one sided and that such a trend could have negative development impacts.

Public authorities must fulfil their responsibilities by ensuring that taxpayers' money is used for socially desirable projects which are in line with development strategies and industrial policy and that scarce public resources are genuinely additional to private finance. These resources should lead to the best possible development outcomes, such as creating decent jobs and generating a fair share of tax income from companies.

THE ROLE OF DFIS AND PRIVATE SECTOR LENDING ARMS OF MDBs

In the last few decades, public development finance to private companies and financial institutions investing in the South was mostly channelled through bilateral development finance institutions (DFIs) and private sector lending arms of multilateral development banks (MDBs).

Bilateral DFIs are either government owned or the government is the majority shareholder. There are only a few exceptions – usually smaller DFIs – such as the Austrian Development Bank (OeEB) that is owned by a private bank but given a public mandate by the Austrian government. Multilateral DFIs and their equivalents, which are usually connected to the international financial institutions (IFIs) such as the IFC of the World Bank Group, usually have greater financing capacity and provide a forum in which governments act together. In terms of their mandate, DFIs generally focus on engaging in high risk investments in sectors with limited access to capital markets.

From the late 1990s to 2008, MDBs have nearly tripled their combined private sector portfolio, from €7.3 billion to €21.24 billion (Perry 2011). The six bilateral DFIs analysed by Eurodad increased their portfolios nearly two-fold between 2006 and 2010. With the exception of Norfund, every DFI has at least doubled its commitments compared to pre crises levels.

DFIs use different financing instruments. By far the most frequent are direct loans to domestic and non-domestic private sector enterprises in developing countries. However, the use of equity – the purchasing of company stocks – as a financing instrument is rising rapidly. During the economic and financial crisis, DFIs balance sheets increased drastically as traditional investors withdrew from developing countries. Sovereign guarantees and preferred creditor status protect their investments in ways that no other financial institution can compete with. At the same time, the drying up of credit markets has fostered DFI expansion, including into new areas, such as trade finance.
Though the majority of DFI lending flows to middle-income countries, DFIs have also expanded their lending to poorer countries. The IFC's committed portfolio in low-income countries has increased nearly four-fold between 2000 and 2010, from €843 million to €3.1 billion. The Dutch DFI, FMO, has almost doubled its investments to Low Income Countries (LICs) from €1.7 billion in 2006 to €3.2 billion in 2010 (FMO 2011), and the Belgian DFI, BIO, has more than tripled its corresponding figures, from €30 million to €100 million (BIO 2011).

Protected by their public liability/guarantee and driven by their development mandate, DFIs are in a position to make investments with potentially lower profit and higher risk, but with a higher social return. However, the tendency is to follow market trends and safe investments. On top of this, DFI returns are tax-free and they don't pay dividends, which increases their room for manoeuvre (Dickinson n.d.). Most DFIs work on the basis of being a 'revolving door fund,' whereby profit is reinvested.

Considering their success in generating a return on investment, governments are tempted to present DFIs as a new model for development finance. This would provide a convenient justification for governments using ODA to leverage private finance through DFIs.

WHO PROFITS THE MOST? DRAMATIC RISE OF FINANCIAL SECTOR INVESTMENTS

DFIs and IFIs have historically focused on infrastructure and energy. However, since the global economic and financial crisis, most DFIs and IFIs have massively increased investments in developing countries' financial sectors. According to Eurodad research, over half of the IFC's lending in 2010 was through financial intermediaries, with other bilateral or multilateral DFIs following the same pattern. In 2010, lending and investments in the financial sector by bilateral DFIs and IFIs increased on average more than two fold, compared to pre-crisis levels (Kwakkenbos 2012).

A financial intermediary (FI) acts as a broker between the public institution and the private company benefiting from public lending or investments. FIs can be commercial banks, hedge funds, private equity funds, credit unions, or microfinance institutions, among others. The rationale for engaging with FIs is the possibility of reduced transaction costs. As the DFI or IFI has no public banking facilities, this is the only way in which they can engage directly with micro, small and medium enterprises (MSMEs). Currently, commercial banks are by far the largest recipients of IFI and DFI funds going to FIs, although private equity funds are quickly becoming a favoured vehicle (ibid).

However, questions of the actual practice arise as particularly hedge funds and private equity funds are normally very opaque in both portfolio and investment strategies. Besides general statements of intent, it is almost impossible for external stakeholders to actually track whether DFI and IFI lending and investments reached the intended beneficiaries (MSMEs). This is due to the fact that the financial institutions intermediating between DFIs and MSMEs do not provide disaggregated data in their annual reports on projects and companies supported by them and on development impacts. The DFIs themselves claim that providing this type of information is not possible due to commercial sensitivity, the fact that money is fungible and because public and private funds are mixed once invested in private financial institutions.

MOST EIB AND IFC SUPPORT STILL GOES TO COMPANIES IN RICH COUNTRIES ... AND IN TAX HAVENS

DFIs find it difficult to resist the temptation of supporting companies domiciled in donor countries rather than in developing countries. Research conducted by Eurodad in 2010 (Ellmers/Molina/Tuominen 2010) revealed that the lion's share of IFC investments, namely 63 %, went to OECD based companies and unfortunately, not much has changed since then. Of the EIB projects where beneficial ownership could be traced, 35 % (€1.5 billion) went to OECD based companies. The fact that a large portion of investments made by IFC and EIB ends up supporting firms headquartered in developed countries, puts into question their ability to engage as development institutions and their contributions to poverty eradication and real development impact. In order to demonstrate that they have clear development impacts, they must ensure that the majority of their investments have clear development and financial additionality.

Moreover, 25 % of EIB investments have a beneficial owner based in a secrecy jurisdiction. This is particularly worrying as revenues from those investments are probably not properly declared and taxed. An estimated 1 trillion U.S. dollars of illicit financial flows yearly exits developing countries. These flows are essentially money lost by developing countries as they are untaxed and thus provide no social or distributive element for the developing country (Romero/Ruiz 2011).

THE CONCEPT OF 'LEVERAGE' – POORLY DEFINED AND PROBLEMATIC

One of the latest arguments DFIs and aid agencies use to justify their investments in the private sector is that by cooperating with the private sector they can leverage significantly more finance into their projects than development institutions could ever raise alone. Leverage in this case refers to 'the ability of a public financial commitment to mobilize some larger multiple of private capital for investment in a specific project or undertaking' (World Bank Group et al. 2011).[4]

The concept of leverage is clearly behind innovative financing mechanisms such as blending ODA with loans. This mechanism is currently being pushed by the European Commission (EC) and bilateral DFIs and could be seen as a potential 'sea change' of development finance, since it effectively shifts ODA from the public to the private sector.

The term **'blending'** refers to a mechanism established by the EU to mix EU ODA with loans from public finance institutions for the purpose of supporting the private sector. Blending grants and loans is nothing new in Europe. Other multilateral and bilateral development finance institutions, such as the EIB, the German KfW and the French AFD, have for years used their own grant resources together with loans for infrastructure and other development initiatives. However, what is new in the current context is the wider use of EU blending instruments to leverage private finance from different sources and the new narrative that is being developed around it.

Currently, European blended money is being channelled through different facilities carried out by the EIB and by the EC. ODA money from Member States is used to finance the European Development Fund (EDF), the main instrument for providing community aid for development cooperation. It consists of several instruments, among them are grants managed by the EC, and risk capital and loans to the private sector managed by the EIB under the Investment Facility. At EU level, blending is being implemented through eight facilities, which cover all the geographical regions of EU-development cooperation. So far the allocation of funds has been limited with €1.5 billion from the EDF, the EU budget and EU Member States over the period 2008-13, whereas the total ODA by the EU and its Member States was over €53 billion in 2011 alone.

However, the EU's rhetoric indicates that blending mechanisms will be used more extensively in the near future. Building on the EC's policy paper called 'Increasing the impact of EU Development Policy: an Agenda for Change,' (EC 2011) 'the EC envisages a higher percentage of EU development resources to be channelled through existing or new financial instruments,' namely, blending facilities. Additionally, a new EU Platform for Blending in External Cooperation was set up in December 2012 to facilitate the scaling up of these blended resources.

However, there are serious doubts whether this is the right way to reach development objectives in the context of budget constraints. Civil society groups, including Eurodad, have highlighted the following critical problems (Griffiths 2012):

- Additionality cannot be assumed just because public institutions are co-investors with private funds: It could well be that DFIs or aid agencies are actually replicating existing investment or following market trends instead of investing in areas with a potential positive development impact and where private investment is not currently flowing. In the case of the existing blending facilities a recent study commissioned by the UK Department for International Development (DFID), and conducted by the European Think-Tank Group (Gavas et al. 2011) highlights the risk of financial principles outweighing development principles. Despite positive results, such as speeding up of project implementation, or mitigating social or environmental impacts, an overarching question concerns the guiding principles for project selection. Furthermore, the greater the leverage ratio, the smaller the overall contribution of the public body, and the lower its influence on the design and implementation of the investment. Private investors focus on making money, not on promoting development and trade-offs between their objectives and those of public institutions exist.

- Opportunity costs may be high, but are not carefully considered. Using ODA to financially support private sector investment means that those resources cannot be used elsewhere. Given the current budget constraints, these opportunity costs may be particularly high in countries or sectors where the need for straightforward public investment is high such as in climate adaptation, health, or education.

- Insufficient attention to transparency and accountability. As confirmed by ODI research on blending facilities, issues related to accountability and transparency should be properly addressed. Besides practical impacts on the project outcome, the decision making process is done behind closed doors without clear criteria for project selection and limited information available to ensure efficient public participation and scrutiny. Currently, there is no active CSO involvement in Europe or in recipient countries and national governments in partner countries are barely involved too.

- Potential debt risks for developing countries: By increasingly leveraging debt based finance, EU investments in the private sector could contribute to increased indebtedness of developing countries. This element has not been taken into account sufficiently when assessing the impacts of blending or leveraged finance. In the recent review of the Debt Sustainability Framework (IMF/WB 2012), the World Bank and IMF expressed concerns about the rising levels of private debt and recognised its potential impact on public debt vulnerability. The situation is further aggravated as the Heavily Indebted Poor Countries Initiative and the Multilateral Debt Relief Initiative are coming to an end.

- Unclear monitoring and evaluation methods: If the methodology for monitoring and evaluating development impact is not included at the project selection stage, it is unclear how a possible development impact of the project will be assessed. Environmental, social, and governance (ESG) assessment mechanisms are crucial to determine the financial and development additionality. Monitoring and evaluation help to ensure that scarce development finance is channelled to areas that have demonstrated success in meeting international and national development goals. Evaluations should also include interests and views of the concerned population/citizens to ensure local ownership of the project and to prevent human rights violations and social damage.

MEASURING DEVELOPMENT IMPACT IS DIFFICULT

Currently, there is no harmonised approach amongst the DFIs for measuring development impact. One of the greatest difficulties in evaluating DFI projects and investments is that development impact assessments tend to begin once the key decisions on for whom, how and where investments will be made, are already taken (Bracking/Ganho 2011). This suggests that the additionality of projects is assessed as a secondary aspect of project selection. If the methodology for monitoring and evaluating development impact is not included at the project selection stage, it is unclear how the project will have an effect on development priorities.

The majority of DFIs are signatories to international agreements such as the Equator Principles, the UN Principles for

Responsible Investment (PRI), or other responsible financing frameworks. These guidelines, which include IFC performance standards and similar commitments, tend to be ambiguous, general and often quite weak. Particular concerns arise over whether DFIs operationalise aid effectiveness principles and poverty eradication in their project selection (World Bank Independent Evaluation Group 2011).

Financial intermediaries based in donor countries – the recipients of growing volumes of development finance from DFIs – often have limited local knowledge in comparison to local organisations. This challenges their ability to reach the most credit-constrained companies in recipient countries. As the Dutch DFI FMO acknowledged, in 2010 in Africa 'margins remained under pressure as supply of liquidity from Development Finance Institutions (DFIs) outstripped demand' (FMO 2011). This demonstrates that the traditional hunting grounds of the DFIs are currently flooded with finance and casts doubt on the financial additionality of these types of flows.

The nature of private sector investments, where social outputs are normally not the objective of the private sector partner, makes it difficult for DFIs to demonstrate such effects. The opacity of many financial intermediaries adds to this difficulty.

Thus, it is perhaps not surprising that a report of the World Bank Independent Evaluation Group (IEG) from 2011 found that less than half of the IFC projects reviewed were designed to deliver development outcomes, and just one third of the projects addressed market failures, such as by enhancing the access to markets or employment for the poor.

The IEG report rang serious alarm bells on whether donor governments breach their contract with taxpayers, as DFIs and development agencies are mandated to deliver on poverty eradication and sustainable development as defined by the Millennium Development Goals, Aid Effectiveness principles and internationally agreed development goals. Furthermore, a recent audit report released in February 2013 by the Compliance Advisor Ombudsman (World Bank/Compliance Advisor Ombudsman 2012) – the IFC's independent recourse mechanism – found that the IFC 'knows very little about potential environmental or social impacts of its financial markets lending' and cannot even claim that it meets the 'do no harm" requirement.

The IFC considers itself a leader amongst the DFIs, partially due to the size of its portfolio and its experience in working in the field. Even though the IFC is the largest provider of development assistance to the private sector, it can not demonstrate that its investments deliver on development objectives, or that they do not actively detract from them.

CONCLUSIONS

Channelling public development finance through DFIs to the private sector is increasingly regarded as a new model for development assistance. It is supposed that if DFIs can use a small amount of ODA to create large returns by leveraging additional finance, while having a development impact, this should also work with larger amounts. However, a comprehensive analysis of the development impact of DFI investments must be undertaken before this is even considered.

In order for investments in the private sector to become a truly developmental tool, the DFIs need to demonstrate better that they engage exclusively in pro-poor and equitable investments, where additionality is guaranteed and development impact is held above financial returns. DFIs need to harmonise their efforts better to ensure that their investment strategies are in line with development goals and principles of aid effectiveness that have been agreed upon on an international level. Currently the DFIs have a fragmented approach that only at times is consistent with these principles.

The cases of the IFC and the EIB show that there is not enough focus on using development finance for the private sector in developing countries, which can provide much needed revenues for social policies and public goods. The overwhelming emphasis on supporting the financial sector of developing countries, particularly large commercial banks and private equity funds, brings into doubt their commitment to poverty eradication and the achievement of the Millennium Development Goals.

The increasing reliance on financial intermediaries must be accompanied by increased transparency to ensure that public resources are invested in programmes with clear development impacts. An assessment should be made that determines which types of financial intermediaries are most appropriate for development finance.

DFIs and aid to the private sector in general must demonstrate clear financial and development additionality. Before scaling up this form of development cooperation, donors should be cautious and ensure this modality lives up to its promises.

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1 For more information see World Investment Report 2012 (UNCTAD 2012).

2 The World Bank annual report 2011 demonstrates that financial support for the provision of public goods has either stagnated or decreased, whereas financial support for financial infrastructure and private sector development has drastically increased. For more information please see World Bank (2011): Annual report 2011.

3 By external public finance we mean finance where a state backed agent, such as Development Finance Institutions (DFIs), or state-backed multilaterals, provides the funds directly or guarantees lending. This does not include private-private flows, such as Foreign Direct Investments or remittances.

4 However, DFIs, IFIs and aid agencies have introduced confusion into the issue by applying the term to related but different areas, such as public investments intending to change market behaviours, pooled financing of various governments, MDBs, private sector, and other sources – of the type used, for instance, in the Clean Technology Fund, or even for policy reforms.