Development finance: Filling today's funding gap

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The Business and Sustainable Development Commission, Chaired by Lord Mark Malloch-Brown and comprised of business leaders from around the world, reports that it will likely require around $2.4 trillion a year of additional investment to achieve the sustainable development goals (SDGs) by 2030. It also estimates that achieving those goals could open up as much as $12 trillion of market investment opportunities in four categories—food and agriculture, sustainable cities, energy and materials, and health and well-being.[1] While that represents an enormous opportunity, it also prompts the question of what options exist to bridge the current gap in financing.

At least four options exist for filling that funding gap:

1. To aggressively pursue efforts aimed at reducing or eliminating trade barriers that inhibit access to markets, impede the movement of goods and services across borders, and discourage foreign direct investment;
2. To increase official development assistance (ODA) from the current flat trend of around $160 billion per year;
3. To generate more revenue from domestic resource mobilization (DRM) and from improvements to the enabling environment for private sector investment and finance; and
4. To increase foreign and domestic investment in low and middle-income countries by ramping up the engagement of the development finance institutions (DFIs) and the multilateral development banks (MDBs).

The focus of this paper is on the fourth option—development finance.

Development finance can be broadly defined as the use of public sector resources to facilitate private sector investment in low- and middle-income countries where the commercial or political risks are too high to attract purely private capital, and where the investment is expected to have a positive developmental impact on the host country. Development finance institutions use direct loans, loan guarantees, equity investments, and a variety of other products to support and enable these investments—and to mitigate political and commercial risk.

In recent years, development finance has emerged as an increasingly important tool to fight global poverty and reduce income inequality. In many cases, it has become an important complement to ODA and integral to achieving the SDGs. Whereas the Millennium Development Goals (MDGs) were focused on increasing donor assistance to developing countries, the SDGs include a comprehensive set of objectives for every country and emphasize all forms of finance, particularly from the private sector. Agenda 2030 recognizes that the private sector is not only a source of capital, but also a source of jobs, innovation, technology, knowledge, and practical experience.

Ramping up the engagement of DFIs and MDBs to facilitate much more private capital investment in developing countries could result in dramatic progress towards inclusive economic growth and opportunity. To realize that potential, the DFIs must assert leadership and work together as never before to co-lend, co-invest, and make substantially more capital available at affordable rates.

In the United States context, a vital initial step is to equip the U.S. government with a development finance institution that has all the tools and capacity that other DFIs have in Europe and Japan. The Overseas Private Investment Corporation (OPIC), which was created in 1971 as a spin-off from USAID, is the United States' main development finance institution. OPIC, which has not changed significantly in over 40 years, offers three different products: direct loans and loan guarantees; political risk insurance; and private equity funds.

Direct loans and loan guarantees from OPIC can go up to $350 million and are only available if commercial lenders or financial intermediaries are unable or unwilling to provide the credit on their own. Political risk insurance protects the buyer against expropriation, currency inconvertibility, and political violence and is only available if commercial insurers are unwilling to take on the entire risk themselves. And the private equity funds are created to encourage investment in geographic and/or sectoral priority areas in which insufficient investment is taking place, such as in agricultural supply chain businesses in sub-Saharan Africa. OPIC's participation takes the form of senior secured debt, which means that, upon exit from the fund, OPIC gets its original loan back plus interest, before any of the private equity investors get a return.

In FY 2017, OPIC authorized $3.8 billion in new commitments for 112 projects, and increased its total exposure to $23.2 billion. Currently, it has a limit of $29 billion in total commitments. OPIC charges premiums for its insurance, and fees for it services, and has made more in revenue each year than expenses almost since inception. In FY 2017, OPIC made $262 million and had operating expenses of $70 million. In short, OPIC is self-sustaining and is a moneymaker for American taxpayers.

While these numbers are impressive, the European DFIs (collectively part of the Association of European Development Finance Institutions or EDFI), have commitments of around $45 billion, or twice the size of OPIC. When one compares the total of OPIC and EDFI commitments (which are in the tens of billions) to those made by China's One Belt One Road initiative (which are in the hundreds of billions) the difference is stark, even when excluding China's commitments to projects in Africa and Latin America. Indeed, from 2000-2014, China's non-concessional development investment was $276 billion in more than 4,300 projects in 140 countries.

Beyond the issue of size and breadth, OPIC has other disadvantages vis-a-vis its European and Japanese peers. For instance, OPIC can finance transactions, but unlike its peers, it cannot invest equity in those transactions. This is problematic for several reasons. First, it creates tensions with other investors who resent OPIC having a preferred position rather than investing with them on a more equal footing. Second, it reduces OPIC's flexibility to structure its support for a deal in a way that maximizes its chances for success. If OPIC can provide both debt and equity to some higher risk transactions, then more deals that should get done will get done. Third, the income earned as an equity investor can be used to support further expansion of the agency's portfolio in the future. This is the approach taken at some of the European DFIs where equity investments represent some 50 percent of their portfolios, with the resulting income paying a large part of their operating expenses.

There are several other differences between OPIC and its counterparts that inhibit the agency's ability to support investments abroad. OPIC has no capacity to provide grants for technical assistance or feasibility studies, both of which can help move a project from a concept to a viable transaction. OPIC requires that at least 25 percent of the equity of a deal that it finances be owned by an American citizen. The European DFIs do not have a similar requirement. Finally, OPIC requires that all transactions be in dollars rather than allowing a deal to be done in local currency. While all these differences are perhaps understandable from a policy and political perspective, these constraints have limited OPIC's effectiveness and hurt the U.S. government's ability to work with its allies and compete with the Chinese.

The 2018 BUILD Act

Given these concerns, coupled with the realization that over 90 percent of the capital flowing into the developing world now comes from private sector sources (FDI, philanthropic, and remittances included), and the fact that the U.S. economic diplomacy toolkit has not been updated or modernized in decades, a consensus has emerged around the need for major reform. That led to the drafting of legislation that is now known as the BUILD Act of 2018, or the Better Utilization of Investment Leading to Development Act. The BUILD Act would create a new U.S. International Development Finance Corporation (IDFC) comprised primarily of OPIC and USAID's Development Credit Authority (DCA). As originally conceived, the BUILD Act also folded the U.S. Trade and Development Agency into the consolidation, but it was ultimately left out of the bill.

The bill's lead sponsors in the House are Congressman Ted Yoho (R-Fla), a leader of the Freedom Caucus, and Congressman Adam Smith (D-WA), both members of the House Foreign Affairs Committee. Chairman Ed Royce (R-CA) joined Yoho and Smith as a lead sponsor of the bill. In the Senate, Bob Corker (R-TN) and Chairman of the Foreign Relations Committee, and Chris Coons (D-DE) are the lead Senate sponsors.

The BUILD Act addresses every major shortcoming of OPIC and provides additional authorities that will enable the new IDFC to collaborate and/or compete with its DFI peers, as well as the Chinese. The act allows the new IDFC to take up to a 30 percent equity position in qualifying deals, provides small grant and technical assistance capacity, requires that "strong preference" be given to American companies pursuing a deal, but does not require a U.S. "nexus," and allows transactions to be done in local currency when necessary.

Considerable attention has also been focused on how to strengthen the relationship between the new IDFC and USAID. There are several reasons why this is important, starting with the basic premise that OPIC (and the future IDFC) is not just a business investment facilitation agency, but also a development agency whose mission is to use private capital investment as a means of improving livelihoods and reducing poverty. Yet, USAID is the U.S. government's lead development agency and it has its own Development Credit Authority (DCA) that uses partial credit guarantees to mobilize local financing and encourage private lenders to extend financing to new sectors and regions. In short, they share many of the same responsibilities, but operate in completely different orbits most of the time, which is why the sponsors of the BUILD Act decided to consolidate OPIC and DCA into the new IDFC.

However, the sponsors were not content to simply move boxes around on an organization chart. Rather, they wanted to use the BUILD Act to create permanent linkages between the IDFC and USAID such that there could be no doubt about the importance of development objectives as an integral part of every transaction. To that end, the legislation: designates the USAID Administrator as the permanent Vice Chair of the Board of the IDFC; calls for the creation of a Chief Development Officer to be appointed in consultation with the USAID Administrator, and; establishes a Development Advisory Council (Senate bill only) to provide direction to the IDFC with respect to its development agenda. Many of those provisions reflect input from the development community as well as a very robust executive branch inter-agency review process.

Both the House and Senate bills have been the subject of public hearings and both bills have been marked up and reported favorably out of the jurisdictional committees—one unanimously and the other with a single "no" vote. The bill passed the House on July 17 by voice vote and now awaits action by the full Senate. The broad bipartisan support for the bill and the priority given it by organizations as diverse as the U.S. Chamber of Commerce, the ONE Campaign, the U.S. Global Leadership Coalition, and the Modernizing Foreign Assistance Network have helped propel the legislation forward. Indeed, a year after the Office of Management and Budget recommended "zeroing out" OPIC, the Trump administration has not only embraced the bill, but has proposed an increase in appropriations to support the consolidation and growth of the new IDFC.

While much of the support for the bill is based upon current thinking about the critical role of private capital investment in fighting global poverty and achieving the SDGs, there is also great concern about the development strategy being pursued aggressively by China in large parts of the developing world. Indeed, there are many who believe that the United States, Canada, Europe, Japan, and Australia must offer a compelling counter narrative to China's growing clout as a lender, and in a smaller way, as a donor, or risk losing access and influence in certain emerging market countries.

DFI collaboration and the rise of China

With the new authorities given the IDFC, the U.S. would be able to work with its allies as a co-equal development finance partner. The IDFC could join its peers in co-investing, co-lending, and blending finance. While these DFIs cannot match China's commitments dollar-for-dollar, that is not necessary. Rather, they should play to their strengths by encouraging entrepreneurship and innovation backed up by private capital investment and private sector discipline. By working together, the DFIs can double or triple their individual capacity, avoid competing against each other for who can provide the most subsidy for a deal, and offer regional and sectoral financing programs that will quickly create critical mass.

Yet, to work more effectively together, new attention must be paid to speed and simplicity. One of China's competitive advantages is the speed with which they move once a commitment is made. They normally speak with one voice and are able to start work almost immediately upon signing a deal, whereas western-style transactions are often subject to financing or other contingencies that can delay the start of a project for months, or longer.

Rather than requiring a project sponsor to negotiate with each DFI separately, now is the time for the major DFIs to agree upon as much standardization in deal making as possible. For instance, they should establish a common set of "due diligence" points, a common and consistent set of metrics for evaluating and measuring success, and common contract language whenever possible. In contrast to their Chinese counterparts, they should continue to stress transparency, openness, and accountability, particularly when a transaction involves a local government.

Examples abound of countries that agreed to accept Chinese financing for large infrastructure projects, but are now struggling, or will struggle, to service the debt when it comes due. Given the lack of transparency with which many of those projects were negotiated, the public is unaware of the financial burden that lies ahead, much less the consequences of a failure to make those payments.

One recent highly-publicized example is the Hambantota Port Project in Sri Lanka financed by China. The project failed to generate the ship traffic and revenue necessary to cover the debt. As a consequence of their delinquency, the Sri Lankan government handed over control of the port and 15,000 acres surrounding it to the Chinese for 99 years.[2] That port project represents one of the more sensational "bad deals" made by a host government with the Chinese, but there are others. Moreover, there are plenty of host governments who don't see any alternative to what China is offering. That is why it is so critical for the DFIs and the MDBs to redouble their efforts to meet this challenge.

With respect to the DFIs, if they are able to collaborate on regional and sectoral financing programs, then no single institution bears too much risk in the partnership. Also, by standardizing and accelerating the process for adding assets to the portfolio, the cost of each transaction should come down and they can build a diverse mix of projects in which under-performance by a single asset can be mitigated or offset by the steady performance of others in the portfolio.

The challenge facing the MDBs is somewhat different. As the largest sources of development finance either globally or in their respective regions, many have the capacity to take on higher risk projects. However, few do, as evidenced by the report of the Blended Finance Task Force, which was created by the Business and Sustainable Development Commission.[3] That Task Force found that, currently, the MDBs have capital mobilization ratios of less than 1:1 across their portfolios. In other words, for every dollar of capital an MDB commits, it mobilizes less than a dollar of private investment.

A second finding of the Task Force was that private sector activities only account for around 30 percent of MDB activities, and that their private sector arms only mobilized $2, or less, of private capital for every $1 of MDB commitment. Specifically, in 2016, the MDBs committed a total of $40 billion in financing, which helped mobilize $60 billion in private finance for a grand total of $100 billion. A more appropriate leverage ratio would be $1 of commitment mobilizing $4 of private capital.

There are several reasons for this, but an important one is that 95 percent of the MDB commitments are in the form of direct loans while only 5 percent are guarantees, even though the guarantees generated almost 45 percent of the private finance mobilized. A second reason is that, despite their mandates, most of the MDBs are risk averse. They much prefer deals in more stable and predictable markets and they rarely take the higher risk tranche in individual deals, even though there is no player better suited to handle that risk.

The Task Force's response was to recommend setting ambitious targets for the MDBs to pursue in terms of private capital mobilization and building up their team capacity to engage more effectively with private sector players. They suggested that a shock wave needs to be sent through the system to change old habits. However, as long as some of the MDBs believe that taking on riskier projects could do such grave damage to their balance sheets that they might be downgraded by the credit agencies, it is unlikely that mere exhortation will have the desired effect.

An approach that might stand a better chance of succeeding would be to encourage one or more of the larger MDBs to create, or carve out, an off-balance sheet pool of resources committed to supporting higher risk private sector projects in which the returns could be much lower than normal. This fund could attract contributions from other sources, both public and private, and could be governed by those who helped capitalize it. It could offer a variety of products to higher risk projects, but should emphasize those products that were most effective in mobilizing more private capital. Such an off-balance sheet fund could incentivize MDBs to collaborate rather than compete, as well as increase their capital mobilization. Access to the fund's scarce risk-tolerant resources could be conditioned on joint MDB project proposals aimed at achieving greater scale.

While other ideas and strategies are most certainly under consideration in the development finance world, time is short and creativity is essential if real progress is to be made toward the SDGs. Failure to act will only exacerbate the gap between low- and middle-income countries in the world, and leave far too many with no option but to reluctantly accept China's overtures.

1 "Better Business Better World." The report of the Sustainable Development Commission. January 2017. http://report.businesscommission.org/uploads/BetterBiz-BetterWorld_170215_012417.pdf.

2 Abi-Habib, Maria. "How China Got Sri Lanka to Cough Up a Port." *The New York Times*. June 25, 2018.

3 "The State of Blended Finance." Business & Sustainable Development Commission Working Paper. July 2017. http://s3.amazonaws.com/aws-bsdc/BSDC_and_Convergence__The_State_of_Blended_Finance__July_2017.pdf.