Development funds for the private interest?
10 Frequently Asked Questions

Eurodad briefing
March 2011

1. How did it all start?

The involvement of private finance and the private sector in development is not a new phenomenon. Private capital has flown into developing countries for decades. It was not until the 1990s that donors and International Financial Institutions (IFIs) alike started channelling larger amounts of public development finance in support of private sector investment in developing countries.

In the 1990s development finance institutions and bilateral aid agencies dramatically increased the use of public private partnerships (PPP). This increase filled in the gap left with the withdrawal of the state in public utilities, essential services and other state-owned enterprises. This decade saw the emergence of project finance to encourage the participation of private finance in investments in developing countries. Bilateral and multilateral development finance institutions (DFIs) and export credit agencies (ECAs) have played a strong role in bringing project finance to its current level. In the decade of the 2000s these institutions experienced a massive increase in their investment portfolios – as much as a 400% increase in the case of the IFC.

The results of these experiences in the 1990s were far from successful: private investments in the sectors that most effectively reduce poverty were much lower than expected. Across the developing world riots and unrest grew as access to essential services became less affordable to the poor. For the investor’s community, the decade ended with low returns and a withdrawal from countries that were devastated by the financial crisis that swept Asia and other emerging countries at the end of the nineties. Instead of analysing the weaknesses of the model, IFIs and DFIs took a further step in the decade of the 2000s by increasing the use of financial intermediaries to channel finance to the private sector of developing countries. This was not a safe bet as the financial sector didn’t manage to end the decade of the 2000s any better than the previous one.

In the wake of the recent global financial crisis, both bilateral and multilateral development finance institutions and development agencies are looking at private finance as a ways to fill in the gaps of slimming aid budgets after the crisis. They are also increasing the prominence of the role of the private sector in development to supposedly boost developing countries’ productive capacities. Civil society is concerned that this may provide an excuse for donors to not live up to their aid pledges. Without a serious and in-depth assessment of the failure of this model it is hard to see how this approach shall be successful in contributing positive development outcomes.

2. Why use development funds to support private investments?

Underpinning this trend is the rationale that:

- Investment needs in developing countries would not only be covered by public development finance. Development funds should encourage and leverage private capital flows to developing countries.
- Private sector investment in infrastructure or essential services would “off-load” expenditures from the public sector’s balance sheets (helping decrease public debt); and
- The private sector results oriented culture would radically improve the effectiveness and efficiency of projects.

Although some of these may be legitimate claims, the crucial point is that public finance with a clear development mandate is used to support private investments. These investments, by definition, will seek to maximise returns to their investors. The double bottom line pursued by this type of development finance expresses the contradiction of pursuing both profit and development. This contradiction has not yet been resolved in ways which can prove that these development monies are effectively contributing to poverty eradication.
3. What type of development finance is channelled to the private sector?

Two main types of public development finance that are typically channelled to the private sector:

1) **grants** (aid from development agencies) that match private investments in specific projects;
2) **and non-grant resources** (development finance from DFIs and IFIs, which count on paid-in capital by its member states—shareholders—and which raise funds in international capital markets).

Lending and investment by DFIs and the private sector lending arms of IFIs have the double purpose of mobilising private capital flows to developing countries and to deepen developing countries’ financial sectors. They claim their funds:

- Bridge the gap between commercial investment and development aid;
- Help structure investment projects in a way that also encourages private investors to participate; and
- Provide a broad range of financial services to developing countries, such as loans or guarantees to investors and entrepreneurs, equity participation in firms or investment funds and financing for public infrastructure projects.

A good share of these funds does not count as ODA according to OECD DAC definitions; however, these institutions have a clear development mandate. They are reluctant to provide grants to the private sector as they are concerned that this may create market distortions and crowd-out private investors. For this reason they structure their financial products in ways which resemble private financiers.

The role of ODA channelled to the private sector is somewhat different. It claims it can mobilise private sector investments where otherwise there wouldn’t be any, but it cannot really claim it provides additional financial services in these countries. From the perspectives of market advocates, channelling grants to the private sector begs the question of to what extent it is actually distorting the market. From the perspective of ODA advocates the question arises of whether ODA would be more effective in public sector rather than private sector investments, given that the latter is generously catered to by DFIs and IFIs.

4. How much money are we talking about?

There is no current available measure for the total share of public development finance channelled through the private sector. Forthcoming Eurodad research (September 2011) will provide more evidence of the amounts. Anecdotal evidence suggests that this is a sizeable share of the public funds going to developing countries. For instance:

- The World Bank’s International finance corporation channels roughly $4 billion a year in private investments in developing countries, which is equivalent to over one third of annual IDA disbursements ($11.2 billion in 2009);
- In 2008 total Multilateral Development Banks lending to private firms was one third of total MDB lending;
- Within Europe, in 2009, the total combined investment portfolio of DFIs gathered under the European DFI network was over $20 billion, roughly equivalent to one third of total EU ODA.

5. Where do funds come from?

Development agencies channel a share of their ODA budgets to the private sector. They can provide direct grants for private investment projects, or contribute ODA into facilities which provide subsidised (concessional) loans and investments by blending grant and non-grant resources.

DFIs and private sector lending arms of IFIs raise funds in the capital markets which are backed by the shareholders (governments) funds and guarantees. They are typically revolving funds which count on reflows from their lending and investments. Occasionally, shareholders may increase their paid-in capital, through general or selective capital increases or replenishments rounds.

6. How do these institutions leverage private finance?

DFIs and the private sector lending arms of the IFIs
ODA for the private sector has somewhat different claims: it says that grant components allow private investments to implement measures with positive development impacts that otherwise may not have been implemented. It also claims that the existence of a grant component in private investment helps mobilising private sector funds. European ODA funds for private sector projects, which are managed by the EIB, also measure their leverage ratios and claim that in some instances each euro granted by European donors mobilises an additional €9.9 from private sources.

7. How is money disbursed?

ODA channelled to the private sector can take the form of a direct grant to a specific private investment project – by setting up consortiums with private companies, challenge funds or similar agreements. ODA can be used to provide technical assistance targeting issues such as investment climate, regulatory frameworks for private sector investments, corporate governance, and other related issues. Development agencies are increasingly contributing ODA into special purpose facilities or trust funds which provide subsidised (concessional) loans and investments, by blending grants (European Development Fund) and non-grant resources (EIB, DFI or other private financiers). Facilities which can provide loans are jointly set up and / or managed by IFIs or DFIs rather than the development agency itself, which does not have the mandate or technical capacity to undertake lending activities.

DFIs and the private sector lending arms of IFIs have a broader range of market based mechanisms or financial services to invest and lend to the private sector operating in developing countries. They provide advisory services and a range of financial services including:
- Equity and quasi-equity investments;
- Risk management products;
- Structured finance;
- Trade finance;
- Intermediary services.

DFIs and IFIs have dramatically increased their use of financial intermediaries (intermediary services) to deepen developing countries financial services and reach out to micro, small and medium enterprises (MSMEs) which otherwise they claim they could not reach. The network of European DFIs states in a recent publication that, for this purpose, they use specialised global investment firms like SEAF and the Emerging Market Private Equity Association (EMPEA); they also refer to an ongoing initiative to investigate SME best financing practices, under way by the SME Finance subgroup of the G20 process led by SA and Germany. Nevertheless it is still unclear to external observers how the financial intermediaries prioritise investments with the highest development returns and how they track the developmental impact of these investments and then report them to their DFI and IFI investors.

Some examples of the investment funds established or supported by DFIs and IFIs include:

- Africa healthcare fund: participated by the IFC, AfDB, and the DEG. The fund is managed by the private equity firm Aureos Capital. Three of their four offices are based in opaque jurisdictions according to the TJN Financial Secrecy Index.
- Fundo de Investimento Privado Angola (FIPA): Norfund along with Banco Africano de Investimentos (BAI) has invested in FIPA, an entity which is incorporated in Delaware (an opaque jurisdiction according to the TJN FSI), with a representative office in Angola, where the management team operates.
- Fidelity Capital Partners Limited (FCPL): a Ghanaian private equity firm supported by SIFEM and FMO.

8. What sectors receive the most funding?

Sectoral distribution of the portfolio changes across the diverse institutions that provide funding for the private sector in developing countries. The share of these institutions’ portfolio channelled to the financial
sector has dramatically increased in the recent years and it ranks first or second in the sectoral distribution of most DFIs and IFIs. For instance:

- IFC’s lending and investment in low-income countries targets mostly telecommunications followed closely by the financial sector (which includes investments in financial intermediaries);
- EIB’s Investment Facility (funded to a large extent with European ODA from the European Development Fund), which channels funds to a large number of low-income countries, lends and invests more than half of its portfolio in the financial sector.

The shift towards support for the financial sector is partially the results of the increasing use of financial intermediaries to channel public development finance towards the private sector. This trend marks a change in the way these institutions do business. In the last century they usually invested directly in infrastructure, agriculture, manufacturing and other type of projects hand in hand with private sector companies (project sponsors). At the turn of the century, the use of project finance and of financial intermediaries started mobilising larger funds from private financiers other than those invested by the project sponsor. This marks a clear diversification of the type of private firms directly or indirectly supported by development finance institutions, bringing into this business a large number of private equity funds, investment and debt funds, and other private financiers.

9. Are profits made at the expense of development impact?

The development impact of publicly backed private finance and private sector investments in developing countries is unclear.

ICF’s own research argues that financial performance of client companies is highly correlated with development outcomes, as well as with environmental and social performance. NGOs are critical of this research and on the existing institutional mechanisms intended to track the development impact of these funds. The methodology used in the IFC research suffers from grave circularities, as financial performance is a key component of how the IFC measures development outcomes (given that financial performance is a criteria to determine whether a project had positive development impacts, it is unsurprising that projects with positive financial performances also had high development outcomes ratings).

There is little independent research on the development impact of public funds channelled to private sector firms, including financial institutions which lend to private sector companies. This is a gap that needs to be filled, both by independent research conducted by NGOs and academics, and by independent research commissioned by development finance institutions which support private sector investments. This research would provide a much-needed complement to their internal tracking mechanisms.

10. What are the blind spots of this business?

Whereas few would contest that there is a clear role for private sector investments and private finance in development, the use of public development resources to support private investments must guarantee that no compromises are made between the for-profit rationale of private sector firms and private finance, and the development mandate of public development finance institutions.

External observers including CSOs are not satisfied with the poor evidence provided by DFIs, IFIs and bilateral agencies on how these public funds with a clear development mandate are contributing to generate positive development outcomes. The ways in which public development finance is currently channelled to the private sector raises several questions:

a) What are the criteria that should be followed to select the investments with highest development impacts? What are the operational policies in place which guarantee that development returns are the overriding criteria for project selection, besides and beyond expected financial returns?

b) What are the operational policies in place in DFIs and development agencies to ensure that their funding is supporting genuinely responsible private sector investments?
c) What tracking systems should be in place to ensure appropriate monitoring and evaluation of development impacts?

d) How do DFIs ensure that the increasing share of funds channelled through financial intermediaries complies both with appropriate selection criteria and monitoring systems to ensure that public development finance is used responsibly and contributes to positive development impacts?

e) Given the breath of financial instruments and resources devoted by bilateral DFIs and the private sector lending arms of IFIs to support private sector investments, should ODA be used at all to support private sector investments?

Most of the questions above go unanswered. CSOs need to urgently push DFIs, IFIs and development agencies to make sure that the share of their funds channelled to the private sector, including to private financial institutions, effectively contribute to poverty eradication.
Eurodad

Eurodad (the European Network on Debt and Development) is a network of 58 non-governmental organisations from 19 European countries who work together on issues related to debt, development finance and poverty reduction. The Eurodad network offers a platform for exploring issues, collecting intelligence and ideas, and undertaking collective advocacy.

More information and recent briefings are at:
www.eurodad.org

EURODAD Information Updates:
Subscribe free to EURODAD’s newsletter
“Development Finance Watch”:
Notes


