DEVELOPMENT THROUGH INVESTMENT? A BRIEFING ON CURRENT REFORM EFFORTS AT BIO-INVEST

November 2014

BRIEFINGPAPER

SUMMARY

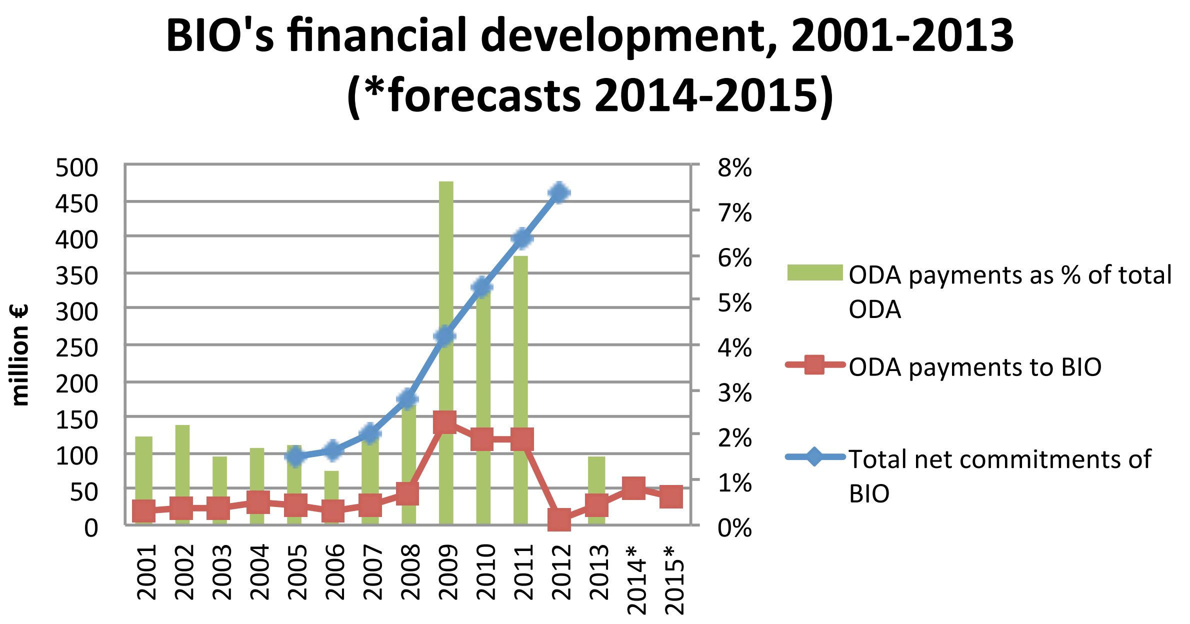
The Belgian Investment Company for Developing Countries (BIO-Invest) was established in 2001 as the Belgian bilateral development finance institution. BIO uses public ODA to support the private sector in developing countries through different financial instruments (loans, equity and quasi-equity). Since 2012, following a public discussion on its role in development cooperation, BIO has been engaged in a reform process. This briefing paper aims to present the main orientations of ongoing reform efforts and highlights some of the remaining challenges for the coming period. Our overall assessment is that the reform is a step in the right direction, but additional measures are required. Stakeholder scrutiny will be necessary to ensure these measures fully align BIO with development effectiveness principles.

INTRODUCTION

In February 2012, 11.11.11 published an evaluation of BIO-Invest giving rise to an intense public and political debate.[1] In December 2013, following an official evaluation, a new law was adopted defining the mandate and objectives of BIO and in April 2014 a first management agreement was signed between BIO and its sole shareholder, the Belgian state.

BIO'S FORMAL EVALUATION

The 'special evaluator', an independent unit tasked with evaluating Belgian official development aid, made a number of interesting observations and highly useful recommendations but ignored the political nature of the necessary reforms. Together with other civil society organisations, 11.11.11 has been challenging the business model of Development Finance Institutions based on using development resources to leverage private finance to provide acces to finance at market rates for private sector companies in developing countries.[2]



Source: Author's calculations, based on BIO's annual reports and DGD's statistical reports on Belgian Development Assistance. Forecasts based on management agreement between BIO and Belgian state.

11.11.11
VECHT MEE TEGEN ONRECHT

BIO'S EVALUATION: STRIKING FINDINGS AND RECOMMENDATIONS

Following 11.11.11's report and a debate in Parliament, former development minister Paul Magnette (PS) ordered the 'special evaluator for development assistance' to conduct a formal evaluation of BIO. As a result of bugetary constraints, the evaluation was done in two phases – a desk study (august 2012)[3] and field visits (October 2014)[4]. Civil society organisations were represented in an 'advisory committee' charged with proposing potential approaches and following up on interim reports.

Findings

- There is a certain tension between development efficiency and required financial returns, especially in PE funds. The mandate of these funds is often so broad that less development-related investments end up in their portfolios.
- BIO and other DFIs make limited use of the possibilities to influence the mandate of intermediary funds
- BIO's activities are incoherent with other activities of bilateral development cooperation (BTC). There is no structural cooperation with NGO's.
- Belgian embassies are often unaware of BIO's activities and vice versa
- BIO's monitoring system does not track indicators consistently and lacks indicators for indirect effects
- Financial targets prevail for SME funds which may be at the expense of environmental and social aspects.

Recommendations

- Take effects on sectors, local environments and economies into account when analyzing potential investments
- Influence intermediaries' structures and strategies in order to make smaller and more development-orientated investments and make clear agreements on investment size
- Try to acquire resources that are exempt from the required return to make risky but highly relevant (from a development perspective) investments in SMEs.
- Reform the current monitoring and evaluation tool so it suited to assess both expected and actual development impacts

NEW LAW AND MANAGEMENT AGREEMENT

Political leaders did not wait for the full results of the evaluation before starting negotiations to reform BIO. In July 2013 former minister for development cooperation Jean-Pascal Labille (PS) announced his reform plans aiming to enhance development relevance of BIO's investments, integrating BIO in the Belgian aid system and strengthening efficiency and transparancy of its governance structures.[5] The government's reform plans were approved by Parliament in December 2013.[6]

In accordance with the new legal framework, BIO signed a first management agreement with the Belgian state in April 2014.[7] This agreement aims to detail BIO's missions, values, principles, main strategic pillars and methods for the period between 2014 and 2018.

Required rate of return

11.11.11's report found that there is a clear trade off between financial returns and development outcomes. Financial returns take precedence over development outcomes as a result of the rate of return required by BIO's shareholder, the Belgian state.[8] This observation was confirmed by the special evaluator's report arguing that 'the required rate of return is often an obstacle to more risky, innovative financing'.[9] Concerns about maintaining the required return rate, constraining more development oriented investments, were also voiced by members of parliament.[10]

Focus on MSMEs

A key point in BIO's reform is an increased focus on micro, small and medium-sized enterprises (MSMEs) - especially in the agricultural sector - and 'social enterprises' such as cooperatives. MSME development is expected to foster 'inclusive growth' and reduced inequalities, mainly in rural sectors. BIO will work to increase MSMEs' acces to finance at 'acceptable interest rates', enhance competitiveness through technological innovation and strengthening technical and governance capacties.

Currently, the notions of 'MSME' and 'enterprise in the social economy' are not entirely clear. BIO applies the MSME definition of the European Commission based on a company's turnover (maximum € 50 million) and balance sheet total (maximum € 43 million). BIO seems to aim for the top tier of mainly large medium-sized enterprises that have the capacity to absorb substantial credits in the area of € 1 million. Such requirements may conflict with the ambition of targeting MSMEs in rural areas where financing needs in the so called underfinanced 'missing middle' are between € 7 500 and € 750 000.[11]

Another import feature of BIO's strategy is the establishment of the 'MSME Development Fund' aimed at financing feasibility studies and technical assistance programmes. Grants are limited to 50% of the total project cost and only clients are eligible. According to current forecasts, € 170 million will be allocated to BIO between 2014 and 2018 including € 8 million for the grant-based MSME Development Fund. Civil society organisations, including 11.11.11, have raised concerns whether these conditions will allow the fund to increase acces to finance for innovative, developing relevant projects in fragile economic contexts (such as low-income countries).

Focus on investment through intermediaries

The special evaluator concluded that additionality of indirect investments (through financial intermediaries) is generally lower, as fund managers do not consider it to be a priority. The main rationale for indirect investments is cost effectiveness. Interestingly, the special evaluator's report calls for an alternative approach to indirect investment. It advises reaching out to small and medium enterprises through specialized private equity funds or banks in which BIO's influence is guaranteed to control investment strategies. As a default option, the evaluator advises BIO to establish new, innovative funds that target small SMEs in BIO's priority areas and sectors.
Civil society organisations have raised concerns regarding intermediary investments by DFIs. Intermediary funds are often problematic in terms of confidentiality and essential development effectiveness criteria such as transparency and accountability.[12]

Exit from tax havens?

Like most Development Finance Institutions, including the World Bank's IFC and the EU's EIB, BIO channels investments through financial intermediaires based in notorious tax havens such as the Cayman Islands and Mauritius. The special evaluator did not consider such structures to be problematic. These conclusions were unconvincing, however, given the limited information (lack of detailed numbers on taxes paid, real earnings, etc.).

The legislator treated the issue as a matter of policy coherence and decided to exclude investments structured in jurisdictions that a) refuse to negotiate automatic information exchange agreements with Belgium after 2015; b) have not successfully passed phase 1 and 2 peer reviews of the OECD's Global Forum on Transparency and Exchange of Information for Tax Purposes and have been labelled as 'non-cooperative' for more than one year; and c) countries that levy a corporation tax at a nominal rate which is less than 10%. In addition, the management agreement provides special precautions to unlawful profit shifting (transfer pricing). These measures go well beyond those of leading DFI's such as EIB, EBRD and the World Bank's IFC.[13]
At this stage, investments in Luxembourg, Switzerland and the Cayman Islands appear to be forbidden, and BIO seems to have a concrete plan to withdraw from these jurisdictions by 2017. Investment funds in Mauritius however, although they are commonly known to specialize in aggressive tax planning in Africa and India, can continue to benefit from BIO's investments.

Monitoring and evaluation

The special evaluator agreed the GPR monitoring tool does not offer sufficient insight in the real development impacts of BIO's investments, is biased towards financial outputs and does not allow for substantive follow-up ex post. As required by the management agreement BIO is currently revising its monitoring and evaluation system. The renewed system needs to be certified by the special evaluator's office. Moreover, BIO is required to make in-depth annual impact evaluations of a sample of investments looking at sustainability, contribution to local economy, positive impacts on the environment, employment, acces to finance for MSME's and fiscal impacts.

Good governance

BIO's reform efforts aim to drastically increase coherence and synergies with other actors of development cooperation. Recently, BIO appointed a new board. Development expertise seems to be an important criterion for board members.[14] BIO's staff was also reinforced with additional expertise in the area of development. The management agreement provides for enhanced cooperation and synergy with other actors of Belgian development cooperation. BIO will take part in the preparation and implementation of bilateral aid programmes, will consult more frequently with BTC and collaborate more strongly with representatives in partner countries. Whether this will guarantee sufficient alignment of BIO's future investment strategies with the priorities of beneficiary countries remains to be seen.

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CONCLUSION

Recent reform efforts are a step in the right direction, but thorough scrutiny of different stakeholders will be necessary to ensure BIO takes additional measures to align itself with development effectiveness principles. Nevertheless, these efforts have clear limitations as they remain within the framework of the mainstream DFI business model in which public development funds are used to leverage private investors. Private investment follows market patterns, serves different objectives and is less predictable than public resources. Especially in low-income countries investment in public services and infrastructure remains the absolute priority. Governments need to consider the opportunity costs related to this model.

Based on our assessment of BIO's reform efforts, we recommend policy makers and BIO to:

- Create a special, off-balance facility managed by BIO that is exempt from the required rate of return and enable it to provide innovative financing, test new financing modalities and target beneficiaries at the bottom-tiers of the missing middle.
- Allow for strengthened public scrutiny through regular reporting and parliamentary oversigth. A necessary step is to collect and report detailed information by country and project on financial and non-financial aspects.
- Clearly define targeted MSMEs in terms of size, sectors and governance models. Include enterprises that are owned by producers and their organizations in order to incentivize SME funds to partner with these MSMEs, especially in the agricultural sector.
- Partner with innovative intermediaries in order to reach MSMEs at the bottom of the missing middle. Prioritize working with actors specialized in long-term financing of MSMEs in cooperation with NGOs.
- Develop monitoring and evaluation procedures based on actual outcomes through periodic reviews that are independent from beneficiaries.
- Only invest in companies and funds willing to publicly disclose information regarding owners and report back financial accounts (including profits, number of employees and taxes paid) on a country-by-country basis. BIO should ensure funds in which they invest are registered in the country of operation, or if not, explain why a third jurisdiction is preferred.

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ENDNOTES

1 http://www.11.be/11/11dossiers/artikel/detail/11dossier_doing_business_to_fight_poverty,104282

2 http://www.eurodad.org/files/pdf/520a35cb666a7.pdf

3 http://diplomatie.belgium.be/nl/binaries/eindverslag_bio_fase1_tcm314-207495.pdf

4 http://diplomatie.belgium.be/nl/Beleid/Ontwikkelingssamenwerking/Evaluatie/evaluatierapporten/

5 http://diplomatie.belgium.be/nl/Newsroom/Nieuws/Perscommuniques/os/2013/07/ni_190713_hervorming_bio.jsp

6 Belgische Kamer van Volksvertegenwoordigers, Parlementair Document 53K3062, http://www.dekamer.be/kvvcr/showpage.cfm?section=/flwb&language=nl&cfm=/site/wwwcfm/flwb/flwbn.cfm?lang=N&legislat=53&dossierID=3062

7 http://www.11.be/11/component/one/artikel/detail/detail/bio_krijgt_eerste_beheersovereenkomst,104769
Until December 2013 BIO was partly owned (for 50%) by the Belgian Corporation for International Investment (BMI), a largely state-owned company promoting foreign investment by Belgian private companies. BMI sold its participation in BIO to the Belgian state "because of lack of potential synergies". See: Belgische Kamer van Volksvertegenwoordigers, Parlementair Document 53 3268/001, http://www.lachambre.be/FLWB/PDF/53/3268/53K3268001.pdf

8 The Belgian state has granted BIO 'development certificates' for a total value of € 576,68 million, coming from the development budget and counted as ODA. These capital subscriptions are considered investments (code 8) with no budgetary impact and need to yield a minimum return matching the average rate of return of Belgian linear bonds + 1%.

9 http://diplomatie.belgium.be/nl/binaries/eindverslag_bio_fase1_tcm314-207495.pdf, p. 81.

10 Belgische Kamer van Volksvertegenwoordigers, Document 53 3062/003, p. 11. http://www.dekamer.be/FLWB/PDF/53/3062/53K3062002.pdf

11 http://www.pfsa.be/IMG/pdf_Dossier_BIO_NL_definitief.pdf

12 http://www.eurodad.org/files/pdf/53bebdc93dbc6.pdf

13 http://www.11.be/component/one/artikel/detail/belgische_ontwikkelingsbank_beste_leerling_vlak_belastingparadijzen,116622

14 http://www.bio-invest.be/nl/about-us/organisation.html