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**INNOVATIVE FINANCING FOR
DEVELOPMENT – CONSIDERATIONS
FOR THE EU IN MAKING USE OF
EXISTING AND NEW INSTRUMENTS**

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INNOVATIVE FINANCING FOR DEVELOPMENT – CONSIDERATIONS FOR THE EU IN MAKING USE OF EXISTING AND NEW INSTRUMENTS

ABSTRACT

We discuss the importance for the EU to anchor its actions in developing and implementing innovative financing instruments for development in the latest EU and international policy framework. The most concrete agreement on innovative financing is the Addis Agenda, whose policy recommendations constitute operational commitments aimed at governments, international organisations, the business sector, civil society and philanthropists. However, it should also be recognized that innovative financing for development is not a new concept. In developing and implementing innovative financing instruments for development, it will therefore be of most importance to draw the lessons of EU experience (especially EU blending mechanisms), as well as the innovative instruments used by other donors which are numerous and far reaching. Finally, innovative financing instruments cannot be considered as “one size fits all” products and it will be crucial for the EU to adopt a differentiated sector and geographical approach in developing and implementing innovative finance products and instruments.

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1 INTRODUCTION

BKP has developed the present research paper as part of the preparation of a tender for Lot 6 of the Framework contract for the implementation of external aid 2018 (FWC SIEA 2018). Lot 6 covers Innovative financing for development. Although this paper was not a requirement of the tender dossier, the Consortium under the leadership of BKP has developed such a paper, building on previous research work by BKP related to finance for development¹, in order to provide a framework for discussing the coverage of the Lot. This is especially important given that Lot 6 is a new Lot for which no implementation lessons can be learned regarding thematic issues. The discussion paper has enabled the Consortium to develop a sound theoretical basis for the creation of the Consortium, and we present below its main findings, focusing on the implications for the Consortium's structure and implementation approach.

2 BACKGROUND

Especially since the last economic crisis of 2008 discussions about innovative financing for development have gathered pace. Indeed, in its 2011 Agenda for Change the European Commission recognises that government and donor funds are largely insufficient to cover the substantial investments required to improve living conditions in developing and transition countries. It goes further in singling out one particular financial mechanism, blending, as important in leveraging additional funds. This Lot 6 on innovative financing for development continues to go down this road in mobilising expertise across a wide range of innovative financing related fields.

EU support to its partner countries has consistently evolved over the years, paying tribute to political and economic developments across the globe. Key initiatives influencing the current reasoning behind EU external aid measures are briefly outlined below.

2.1 Millennium Development Goals and the 2030 Agenda for Sustainable Development

The Millennium Development Goals (MDGs) set in 2000 expired in 2015. They targeted the eradication of extreme poverty and hunger, together with seven other objectives. Over the intervening period marked progress was made in achieving the MDG. Recognising in the UN secretary general Ban Ki-moon's words that 'for all the remarkable gains, inequalities persist and that progress has been uneven', a new more ambitious set of global goals was agreed for 2015-2030 in *'Transforming our world: the 2030 Agenda for Sustainable Development'* with this Agenda officially coming into force on 1 January 2016. Its goals extend beyond poverty reduction to, for example, employment and infrastructure development. In addition, its comprehensive view of development specifically includes its economic, social and environmental dimensions.

¹ See e.g. Bienen, D/Ciuriak, D/Ferede T: Financing Ethiopia's Development: Confronting the Gap between Ambition and Means, Ethiopian Journal of Economics, Volume XXII No.2, October 2013: 21-62 (published April, 2015, available at <https://ssrn.com/abstract=2477384>).

2.2 Addis Ababa Action Agenda on financing sustainable development and developing sustainable finance

The recognition of the importance of ensuring that there be sufficient, appropriate financing to enable 2030 Sustainable Development Goals to be met, led to the Addis Ababa Action Agenda ('Addis Agenda') being endorsed by the UN General Assembly in July 2015. This outlines a new global framework for financing Sustainable Development (SD) that *aligns financing flows and policies with economic, social and environmental priorities, whilst ensuring stable and sustainable financing*; and also lists the concrete policy actions required to facilitate the financing of the SD goals in the 2030 programme. The commitments made by governments include a new social compact to provide social protection and essential public services to all, an undertaking to raise assistance to the poorest developing countries, and enhanced international tax cooperation among others.

Its focus on ways of financing SD reflects the decline in foreign direct investment and certain other types of private financial inflows after the 2008 financial crisis, and the small amount of these flows going to fragile developing countries. It also stems from the huge investment needs of the developing world - the UN estimates that achieving the 2030 SD agenda means raising funds equivalent to thirty times the current level of Official Development Assistance (ODA). The Addis Agenda also highlights the need for long term finance. The focus is on funding SD by combining public and private financing (with the private part leveraging on the initial public outlay), and on developing countries themselves being responsible for – or 'owning' - development, as opposed to the international community which is charged with providing an 'enabling' environment for SD.

The Addis Agenda agreements and policy recommendations, in essence operational commitments, were aimed at governments, international organisations, the business sector, civil society and philanthropists; and distilled into seven subject '*chapters*'. These comprise:

- Domestic public resources, which played a leading role in helping finance the MDGs. To increase their contribution, the Addis Agenda focuses inter alia on increasing the efficiency of the tax system and exploring the potential for development banks to finance long-term investments in markets in which commercial banks were not fully engaged.
- Domestic and international business and finance. Changes in existing policy, regulatory and legal frameworks are proposed to facilitate the financing of SD, in a way which takes full account of its economic, social and environmental impact. Financial inclusion and reduced cross border remittance costs are identified as additional policy objectives.
- International development cooperation. This chapter reiterates the need for the economic, social and environmental dimensions of SD to be fully factored in and call for international assistance to increase recipients' resilience to shocks and natural disasters. The need for there to be graduation policies in place, which enable developing countries to have access to finance once they have exhausted their borrowing facilities with multilateral development banks is also stressed.
- International trade as an engine for development, where the capacity for increased developing country trade is explored.
- Debt sustainability. The role of debt relief, debt restructuring, sound debt management, a central debt registry, new financial instruments that could help countries experiencing debt servicing problems, and measures to impede minority bondholders of crisis country bonds, are all highlighted.
- Addressing systemic issues. These issues include the coherence of international financial, monetary and trading systems and their impact on developing countries. This is especially important given the aim that SD should continue to be funded predominantly from domestic resources – domestic funding has advantages in terms of being more stable, aligned with government priorities and manageable than donor funded spending. This chapter covers other issues too including financial stability concerns in respect of unregulated parts of the financial

system and the role of credit rating agencies, as well as the case for increasing the weight of developing countries in international financial institutions such as the IMF so that they can better pursue SD.

- Science, technological, innovation and capacity building. A host of measures are proposed including diversified innovation funds.
- In addition to the seven chapters, there is a concluding section on Data, monitoring and follow up, which proposes an annual Financing for Development forum lasting up to 5 days among other things.

2.3 European Council conclusions on a 'stronger role of the private sector in development cooperation: an action oriented perspective' (12 December 2014)

The EU institutions and Member States were important participants in the process culminating in the adoption of the MDG and the 2030 Agenda for SD. Three particular milestones are especially relevant to the current initiative. The first of these was the publication of the European Foreign Affairs (Development) Council conclusions in December 2014. These conclusions highlight several important principles which continue to underpin EU policy on private sector involvement in SD. These concern the Council's support for a market-based approach, the need to identify the best model for collaborating with the private sector, and the importance of results. Consistent with these principles, it recommends a number of criteria for assessing the quality of particular financing proposals for development projects, including among others: measurable development impact; additionality (meaning that without a development grant, the project would not go ahead); neutrality; transparency; compliance with labour, social, environmental and fiscal standards including respect for human rights; and shared interest. It also flags the need for criteria to be applied with full regard to the context of the project in question. In order to ensure the leveraging of official SD finance, it supports the use of **innovative financial instruments** (IFIs). In this context, it refers to solidarity funds, multi-donor mechanisms, microdonations and blending (of official grants – normally ODA - with loan or equity funding from public and/or private financiers and beneficiary resources such as guarantees).

2.4 European Consensus on Development

Just over a year after the 2030 Agenda for Sustainable Development came into force, the main EU institutions (Parliament, Council and Commission) adopted a new 'European Consensus on Development' in May 2017, which sets out the EU response to the UN's 2030 SD agenda and proposed a new framework for development cooperation in the EU and its Member States. It seeks to respond to current global challenges which have a demographic, economic, social and environmental impact. The Consensus is important given the EU's leading role in global development, exemplified by its provision of more than half the world's development aid (giving EUR 76 billion of ODA in 2016). There will be a mid-term assessment of the implementation of the Consensus in 2024.

The Consensus is a wide-ranging document, which contains sections on the financing needs associated with the 2030 SD Agenda including its innovative components. In particular it recognises the key role of the private sector as an engine for long-term sustainable development and affirms that the EU and Member States 'will support sustainable and ethical business practices and create incentives for private sector investment in global sustainable development.'

It adds that the EU and its Member States will contribute to scaling-up private and public investments in the low-emission, climate-resilient green economy. One key channel for such actions will be the European External Investment Plan (see below), which will include guarantees to lower the risk profile of investment in developing countries and thus leverage additional finance, particularly from the private sector. It will contribute to the attainment of the SDGs, thus helping to tackle the root causes of irregular migration.’

Third, it views the blending of grants and loans as a way to leverage additional private finance, another important means to implement the 2030 Agenda. ‘Blending covers all regions of EU external cooperation in sectors including energy, transport and water infrastructure, support for small and medium enterprises, social sectors and the environment. Stronger engagement of the private sector will be needed, using innovative financial instruments to help attract more private finance for sustainable development, including for climate action. Ensuring additionality, and focusing on development relevance, blending will be used to improve effectiveness and address market failures while limiting market distortions. Blending activities will promote corporate social responsibility, including through the implementation of relevant internationally agreed guidelines, principles and instruments.’ Close partnership with the European Investment Bank (EIB) and other Member States’ financial institutions will be a key feature of EU blending activities.

2.5 European External Investment Plan

Having thus announced its commitment to the 2030 Agenda, the European Commission proceeded to set out a European External Investment Plan (EEIP) in 2016 to encourage sustainable investment in Africa and EU Neighbourhood countries, thus furthering the pursuit of SD goals. This outlined practical ways in which the EU and Member States could implement the Addis Agenda. In particular, it proposed that:

- A new European fund for sustainable investment be established.
- Technical assistance on the broad policy environment be increased to help developing countries better prepare and attract investment for projects.
- The general business development be improved by good governance, the removal of investment barriers and market distortions etc.

It highlighted the weakness of African economic growth and the impact of this on poverty and migration, including to the EU. EEIP investments were to be primarily for economic, social and environmental infrastructures, with projects relating to municipalities, small and medium-sized enterprises (SMEs), microfinance and job creation at a premium. The catalytic role of EU and Member State finance in triggering private sector investment was emphasised in the forecast of its likely impact. Thus, the European Commission predicted that the provision of EUR 3.35 billion until 2020 by the EU, could lead to the overall amount of SD financing being as high as EUR 88 billion – a multiple of over 26 times – should the private sector and Member States play their full part too. (The relevant Communication states that the new European Fund for Sustainable Development (EFSD) is ‘expected to trigger additional public and private investment volumes, mobilising total investments of up to EUR 44 billion, based on EUR 3.35 billion contribution from the EU budget and the European Development Fund. In order to enhance further the firepower and the efficiency of the new Fund, the Commission calls on the Member States and other partners to match these EU contributions. If they match the EU guarantee, with the flexibilities described below, the total amount of additional investment could be EUR 62 billion. If they also match the contribution to the blending, this amount could reach EUR 88 billion.’)

3 KEY CONCEPTS AND FORMS OF INNOVATIVE FINANCING

One key theme running through the above milestone documents on SD is that agreed goals require funding vastly in excess of likely ODA, which means that ODA must be complemented by a marked increase in private finance; and that new forms of finance – innovative financial instruments – will be necessary for this to happen.

However, the terms innovative financial instruments and innovative finance are not used in a consistent manner by participants in the SD debate. Following the World Bank's lead (see <http://siteresources.worldbank.org/CFPEXT/Resources/IF-for-Development-Solutions.pdf>) the terms innovative financial instruments (IFIs) and innovative finance are used henceforth in this paper to denote financing mechanisms for SD which help to:

- (i) generate extra funds for SD by tapping new funding mechanisms rather than traditional ones such as ODA and bonds;
- (ii) enhance the efficiency of SD funding by ensuring shorter delivery times and reduce costs, for example in funding SD in emergency situations;
- (iii) make financial flows more results-oriented, by linking funding to measurable performance on the ground – for example by the donor paying the recipient upon meeting a particular target set for immunisations.

The 'finance products and structures' in section 1 of the Technical Description for Lot 6 and the 'policy issues' set out in part 4 such as blended finance, mainly fall into categories (i) and (ii) above; reflecting this examples of some of them are explored further below.

Attention has tended to focus on (i), given the ambition of the 2030 Agenda SD goals and the bleak outlook for ODA, normally with a view to mobilising additional private funding. IFIs which help here do so by attracting funding from private – and indeed public - investors, for projects which would be perceived as too risky for such investors using conventional financing mechanisms (such as lending to, and equity/bond issuance by the project 'owner'). By removing part of the costs and/or risks of such projects, they provided a catalyst for investors to provide funding for projects which would not otherwise take place.

This chapter will briefly discuss European experience of blending, as well as outline the major types of innovative finance mechanisms, and look at various financial institutions and their experience in developing and using these instruments.

3.1 EU Experience to date (blending)

In the EU's practice, the main instrument for innovative finance is blending. Since the introduction of the Agenda for Change in 2011, the concept of blending was recognized as an important tool to increase the availability and leverage of financial resources. The development and expansion of blending mechanisms has become one of the priorities, stated in the Agenda²: "higher percentage of EU development resources should be deployed through existing or new financial instruments, such as blending grants and loans including mezzanine debt and other risk-sharing mechanisms, in order to leverage further resources and thus increase impact."

² European Commission "Increasing the impact of EU Development Policy: an Agenda for Change," URL: <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX%3A52011DC0637&qid=1412922281378&from=EN>

As an instrument to achieve EU external policy objectives, blending has become a complimentary tool to other financial aid modalities in achieving regional and national sustainable development goals, driving sustainable growth and enabling poverty reduction. Blending is a financial instrument that combines the EU grants with loans or equity from public and/or private financiers, thus providing additional resource leverage, particularly important for large infrastructure projects (energy, transport, telecommunications, agro-industry, etc). The grant is usually provided from the ODA resources, and the loans are administered by public institutions or commercial lenders. The former requires the resource to be used precisely to fulfil the objective to promote economic development, while the latter does not need to be tied to specific targets. Such a combination ensures certain flexibility of blending when compared with traditional financial instruments.

The EU grant element can come in different **forms**, depending on the nature of the projects and its specific requirements, in particular:

- Investment grant and interest rate subsidy;
- Technical assistance especially for the preparation of project (pre-feasibilities, feasibilities, etc.);
- Risk capital (equity and quasi-equity);
- Guarantees (commercial risks against non-payment and non-commercial to cover political risks such as nationalization, war, etc.)
- Collateral revenues from generated carbon credits (both CDM and voluntary carbon markets)

Clearly, each instrument has its own advantages. Investment grants, for example, help to reduce the initial investment and CAPEX project cost; technical assistance can ensure high quality preparation or execution; equity finance attracts additional investment; and guarantees reduce (commercial and non-commercial) risk exposure.

Therefore, blending has become an important tool when markets cannot provide viable financial resources in areas which are vital for sustainable development. In particular, such situations can occur if projects are not "bankable" being insufficiently profitable, having excessive risk profiles, or are carried out in heavily indebted countries. However, blending is not suitable for those projects which do not produce a revenue stream to service the lending component (generated kWh, toll fees, telecom charges, etc.).

Blending operations by the EU are executed through regionally or thematically focused **facilities**. Eight facilities are organized in four Blending Frameworks. The multiplier impact has been over 30 in the case of the 8 EU blending facilities launched since 2007. The essential information, including participating countries, year of launch, budget and sectoral coverage of different facilities is presented in Table 1.

Table 1: EU Regional Blending Facilities

Facility	Participating countries	Year	Budget	Sectors
Development Cooperation Instrument (DCI) Blending Framework				
Latin America Investment Facility (LAIF)	Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Cuba, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Uruguay and Venezuela.	2010	An overall amount of €270 million for the period 2009-2015.	Energy, agriculture, transport, environment, climate change, SMEs, information and communication technologies (ICT) and social services.
Asia Investment Facility (AIF)	Afghanistan, Bangladesh, Bhutan, Cambodia, China, India, Indonesia Laos, Malaysia, Maldives, Mongolia, Myanmar, Nepal, North Korea, Pakistan, Philippines, Sri Lanka, Thailand and Vietnam.	2010	An overall amount of €142 million for the period 2010-2015.	Projects relevant to the climate change objective and "green" investments in areas of environment and energy, as well as in SME's and social infrastructure.
Investment Facility for Central Asia (IFCA)	Kazakhstan, the Kyrgyz Republic, Tajikistan, Turkmenistan and Uzbekistan.	2010	An overall amount of €145 million for the period 2010-2015.	Energy infrastructure, protection of the environment, control of climate change impacts, growth of SMEs, improvement of the employment situations, improving social services and infrastructure, including health and education.
European Development Fund (EDF) Blending Framework				
Africa Investment Facility (AfIF) and EU-Africa Infrastructure Trust Fund (ITF)*	All African countries eligible to receive financing under the EDF regional and national programmes as well as under the intra-ACP programme and the DCI Pan-African Programme.	2015 (2007)*	EU-AITF resources amount to €812 million, of which €647.7 million the European Development Fund (EDF) and the remaining funds come from EU Member States participating in the Trust Fund.	Energy, agriculture, transport, environment, water and sanitation, climate change, SMEs, information and communication technologies (ICT) and social services, support to private sector development, in particular Small and Medium Enterprises (SMEs).
Caribbean Investment Facility (CIF)	Antigua & Barbuda, Bahamas, Barbados, Belize, Dominica, Dominican Republic, Grenada, Guyana, Haiti, Jamaica, St Kitts & Nevis, St Lucia, Saint-Vincent and the Grenadines, Suriname and Trinidad & Tobago.	2012	An overall amount of €70.2 million was allocated to CIF, including €40 million from the regional allocation and €30.2 million transferred from Guyana's EDF National Indicative Programme.	Economic development and growth, integration at regional level and poverty reduction through the mobilization of resources for strategic economic infrastructure projects and for support to the private sector
Investment Facility for the Pacific (IFP)	The Cook Islands, Federated States of Micronesia, Fiji, Kiribati, Marshall Islands, Nauru, Niue, Palau, Papua New Guinea, Samoa, Solomon Islands, Timor Leste, Tonga, Tuvalu and Vanuatu.	2012	For the period 2012-2015, the European Commission allocated from 10th EDF intra-ACP resources an overall amount of €10 million. For the new 11th EDF programming period 2014-2020, the European Commission doubled the indicative allocation for the IFP to €20 million.	"Green" infrastructure, sustainably energy, climate change adaptation, environmental protection, private sector development and improved delivery of social services.

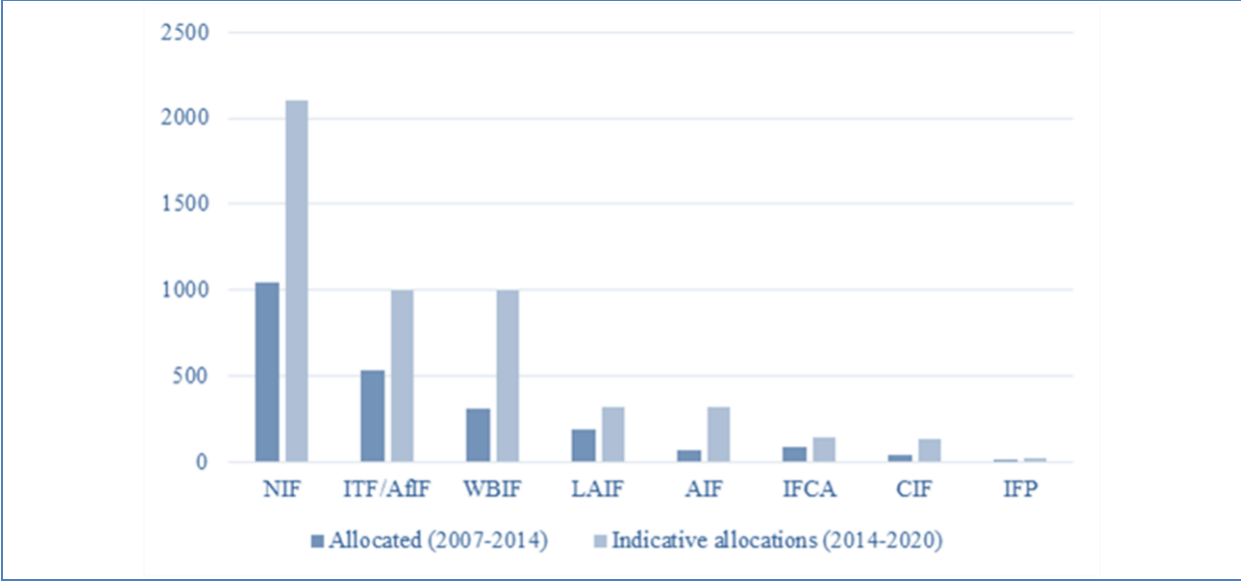
Facility	Participating countries	Year	Budget	Sectors
European Neighbourhood Instrument (ENI) Blending Framework				
Neighbourhood Investment Facility (NIF)	<ul style="list-style-type: none"> ▪ Eastern Neighbourhood region: Armenia, Azerbaijan, Georgia, Republic of Moldova, Ukraine. ▪ Southern Neighbourhood region: Egypt, Jordan, Lebanon, Morocco, Palestine, Tunisia. 	2008	The total amount of NIF support allocated to projects over 2008-2014 comes to €1.072 billion.	Transport, energy, environment and social development, support for the private sector, mainly through investment grants and risk capital operations targeting small and medium-sized enterprises.
Instrument for Pre-Accession Assistance (IPA) Blending Framework				
Western Balkans Investment Framework (WBIF)	Albania, Bosnia and Herzegovina, Kosovo, the former Yugoslav Republic of Macedonia, Montenegro, and Serbia.	2009	Funding of WBIF since 2009 amounts to €1.4 billion, €601 million in grants, €9.6 billion in IFI loans.	Energy, environment, social, and transport sectors, as well as private sector development initiatives.

* EU-AITF covered blending operations 2007-2013 Multiannual Financial Framework and is replaced by AfIF in 2014–2020 Multiannual Financial Framework.

Source: Compiled by the authors from the European Commission website.

In the period of 2007-2014 the overall EU **grant allocation** amounted to more than €2 billion in total, and the indicative budget suggests that this sum might be doubled in 2014-2020. The biggest recipient is the NIF, followed by ITF/AfIF and WBIF (see Figure 1).

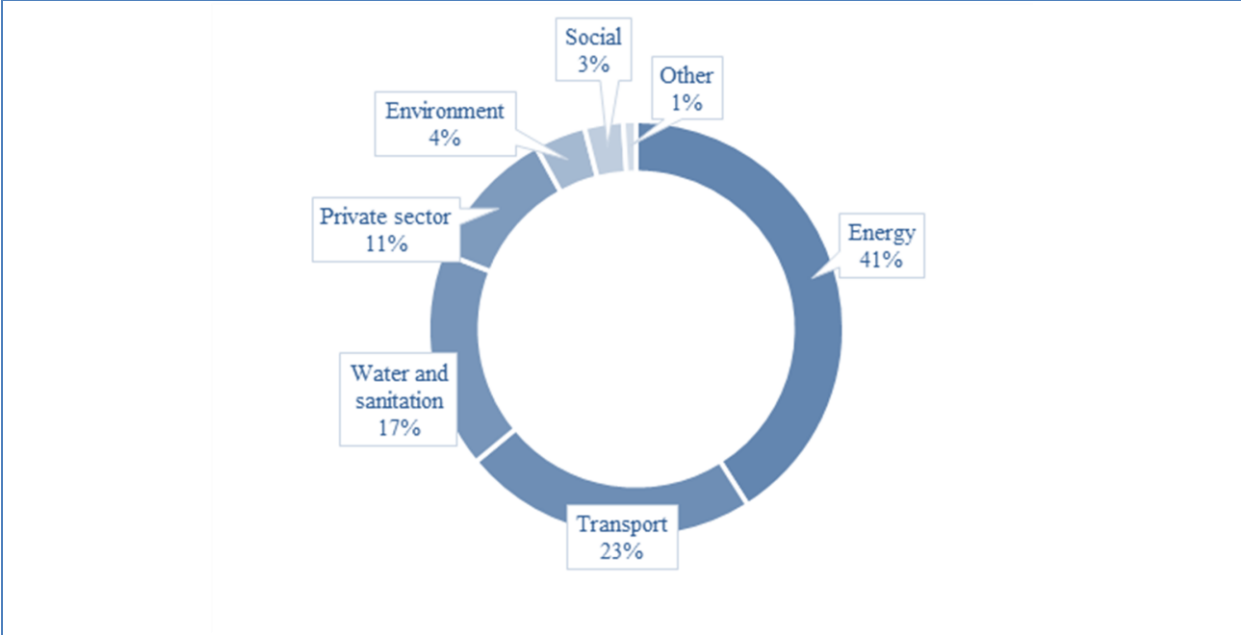
▪ **Figure 1: Grant allocations by Facility (in million euros)**



Source: UTV Working Paper, “Mapping of EU blending,” 2015:1, URL: <http://www.sida.se/contentassets/9a39885e4ac2479493ef5af86ea3fd9b/309f3f20-7c1e-47e6-82a0-a92ff681733c.pdf>

Among **sectors** to which the EU grants were allocated in 2007-2014, the most important appear to be the following: energy, transportation, water and sanitation (see Figure 2). These reflect in general the priorities identified for the sustainable development, with particular focus on infrastructure.

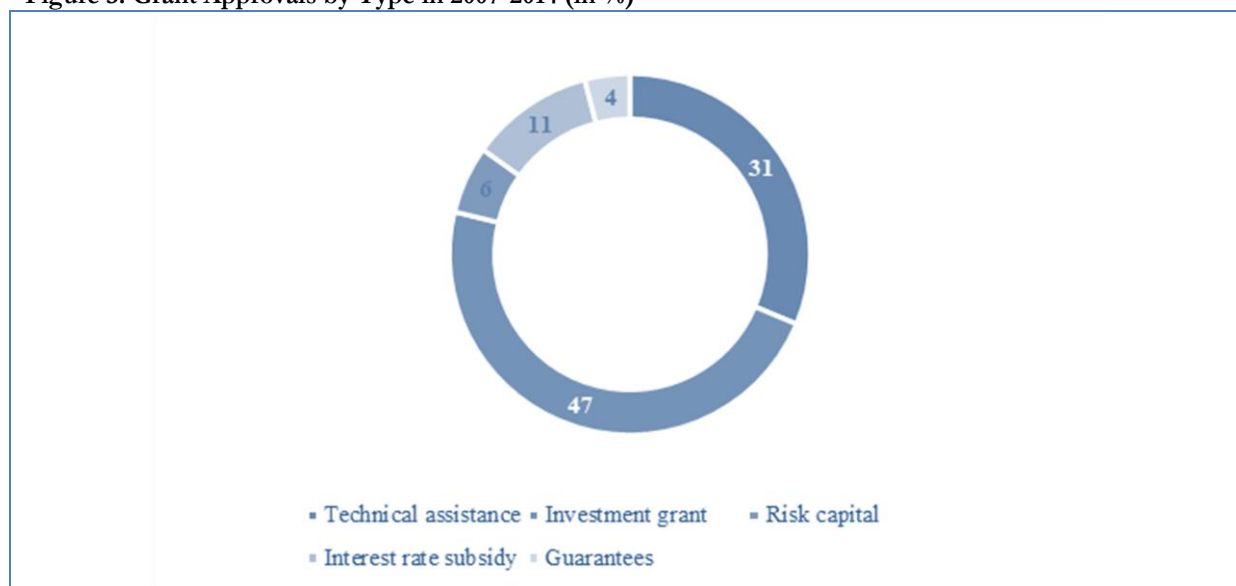
Figure 2: Grant Approvals by Sector in 2007-2014 (in %)



Source: Directorate General for Development and Cooperation EUROPAID, “Innovative Financial Instruments and EU Blending,” URL: <https://ek.fi/wp-content/uploads/Yves-Ehlert-Presentation-Blending-Finland.pdf>

As mentioned above, the **type of finance** varies depending on the nature and specifics of a project. Almost half of the projects are carried out in the form of investment grant; and another 30% as technical assistance (see Figure 3 below). The latter is used mostly within the ITF/ AfIF facility.

Figure 3: Grant Approvals by Type in 2007-2014 (in %)



Source: Directorate General for Development and Cooperation EUROPAID, “Innovative Financial Instruments and EU Blending,” URL: <https://ek.fi/wp-content/uploads/Yves-Ehlert-Presentation-Blending-Finland.pdf>

Even though the concept of blending is not a new phenomenon, the actual use of this mechanism is relatively recent compared to some traditional finance instruments. It is reasonable, therefore, that there are **shortcomings** in the management and execution of the projects with the use of blending. The major concerns can be grouped as follows:

1. *Use / management of resources and monitoring.*

This concern stems from the report of the European Union Court of Auditors, which assesses the effectiveness of blending regional investment facility grants with financial institution loans in the period of 2007-2013. The report finds that “the potential benefits of blending we not fully realized due to Commissions management shortcomings.” (for the full report see http://www.eca.europa.eu/Lists/ECADocuments/SR14_16/SR14_16_EN.pdf).

2. *Evaluation / added value / allocation / transparency.*

A similar concern raised in the abovementioned report is the lack of evidence that blending projects are helping beneficiaries to achieve their development agenda goals. As the EU Court of Auditors mentions, the allocation of EU grants has to be based on “a documented assessment of the added value resulting from the grants.”

3. *Beneficiaries’ concerns.*

Some concerns voiced over using blending as a new financial instrument are pointed out from the development countries’ perspective. In particular, there is ‘fear’ that blending can be used as an excuse for reducing the amount of ODA. In addition, as blending can involve the participation of private sectors, there is a potential for unfair competition and skewed governance structure, whereby European investors may wipe out local participants.

Overall, while there is room for improvement (particularly, in the area of management, evaluation and transparency), blending mechanisms are an important part of development assistance. Given unstable market conditions in most recipient countries, high risk exposure and low profitability in essential sectors, innovative approaches to funds provision, such as blending, are filling the gaps that the markets are not able to fill.

3.2 Other key concepts and instruments of innovative financing

Since there is no internationally agreed definition of innovative finance instruments for development, it is hard to identify the scope of such mechanisms. As a starting point to identify and categorize IFIs, the World Bank report³ provides the following definition:

“Innovative financing involves non-traditional applications of solidarity, PPPs, and catalytic mechanisms that (i) support fundraising by tapping new sources and engaging investors beyond the financial dimension of transactions, as partners and stakeholders in development; or (ii) deliver financial solutions to development problems on the ground.”

The most widely used categorization of innovative finance instruments was first presented in OECD (2011) study, whereby IFIs were divided into four broad groups: (i) new public revenue streams; (ii) debt-based instruments and frontloading; (iii) public-private incentives, guarantees and insurance; (iv) voluntary contributions using public or public-private channels. This classification covers major instruments, but does not allow for additional flexibility in case of new instruments development.

From an analytical perspective, given a broad range of instruments, it is convenient to distinguish different instruments based on multidimensional criteria. Classification proposed in this position paper is the following:

- Instruments that help to mobilize public funding;
- Instruments that help to mobilize private funding;
- Public-private incentives, guarantees and insurance;
- Debt-based instruments and front-loading;
- Instruments that help to mobilize resources through efficiency improvements and debt conservation;
- Voluntary contributions.

These different categories alongside examples of concrete instruments are provided in Table 2.

³ World Bank (2009), “Innovating Development Finance: From Financing Sources to Financial Solutions,” URL: http://siteresources.worldbank.org/CFPEXT/Resources/CFP_Working_Paper_No1.pdf

Table 2: Categories and Examples of Innovative Finance Instruments

Group of instruments	Examples of instruments
Instruments that help to mobilize public funding	<ul style="list-style-type: none"> ▪ New taxes and levies on specific activities, generally of a global nature (e.g. currency transactions, airline tickets, CO2 emissions) ▪ Government sale/ auction of rights of use (e.g. environmental allowances, UMTS licenses) ▪ Allocating IMF special drawing rights specifically to developing countries
Instruments that help to mobilize private funding	<ul style="list-style-type: none"> ▪ Public-private partnerships (PPPs) ▪ Blending: concessionary loans combining public and private funding ▪ Securities / structured funds ▪ Loans/ bonds with performance-dependent repayment terms (e.g. counter-cyclical loans / GDP-indexed bonds) ▪ Ethical funds/ ethical bonds/ diaspora bonds ▪ Loans issued in local currency ▪ The Clean Development Mechanism (CDM) and the Adaptation Fund (AF) ▪ Voluntary carbon markets (VCS, Gold Standard, etc.) ▪ Green Climate Fund Private sector facility ▪ Lotteries
Public-private incentives, guarantees and insurance	<ul style="list-style-type: none"> ▪ Advance Market Commitments (AMCs), IFFIm, GAVI ▪ Sovereign insurance pool (e.g. CCRIF) ▪ Affordable Medicines Facility malaria (AMFm) ▪ Sovereign Index Insurance
Debt-based instruments and front-loading of resources	<ul style="list-style-type: none"> ▪ Debt-swaps (e.g. Debt2Health swap) ▪ Loan/credit buy-downs (IDA Buy-Down, IBRD Buy-Down) ▪ International Finance Facility (IFF) for the frontloading of future development assistance resources
Instruments that help to mobilize resources through efficiency improvements and debt conservation	<ul style="list-style-type: none"> ▪ Results-based Financing / Output-based Aid / Health Impact Fund (HIF) ▪ Weather insurance and catastrophe insurance ▪ Conditional debt forgiveness, debt buy-back and debt-for-development swaps
Voluntary contributions	<ul style="list-style-type: none"> ▪ Person-to-Person (P2P) giving ▪ RED initiative ▪ Massivegood

Source: compiled by authors from different sources.

It is worth discussing in more detail how the most important instruments work. A case in point, some **securities** work by assigning future cash flows from, for example, oil production firstly to interest and principal payments, with the remainder if any forwarded to the issuer. This reduces future debt servicing risks for the holder.

Structured funds may operate similarly; but they also divide overall risk into tranches which cater for different investors' risk appetites. Demand is higher and borrowing costs lower than without such tranches. Such funds are often used to refinance microfinance institutions, whose micro loans serve to secure the international loan provided by this instrument. The overall loan is divided into three tranches. Assignment of losses under the first tranche - which covers the risk of defaulting micro loans in the first instance and is therefore the riskiest tranche - to the aid donor or to the microfinance institutions themselves, encourages private investors to invest in the rest of the fund. The next tranche to cover losses should the first tranche be consumed, is the mezzanine tranche, with the senior tranche only absorbing losses once the mezzanine has been exhausted. The result of such structures is that up to 95% of total financing can be raised from private investors (see https://www.kfw-entwicklungsbank.de/Download-Center/PDF-Dokumente-Development-Research/2012-08-14_FE_IFD_EN.pdf for a detailed explanation.)

In addition, some IFIs include **local** rather than foreign **currency bond issuance** by developing country recipients of SD finance. This is beneficial as it insulates the recipient from foreign currency risk. The success of this new type of bond is likely to require the development of liquid local bond markets. Similarly, the provision of SD loans in the borrower's local currency reduces

its default risk by transferring it to the lender, which is likely to be able to accommodate it within its overall currency risk limits including via hedging techniques. Small and medium sized enterprises which depend primarily on local currency revenues, benefit more than larger enterprises from this form of IFI.

Socially responsible investment models can also increase SD financing. Here the investor, who seeks a social as well as a financial return, is prepared to accept a lower financial return than otherwise if convinced of the social dividend to be reaped. In this case, the willingness of the investor to accept a sub-market rate of return, means that some projects will pass an initial cost benefit analysis which they would otherwise fail and can thus go ahead. This is analogous to the effect of the effective ‘subsidy’ provided by grants with blending finance.

Public-Private Partnerships constitute another way to mobilise additional funding. Here the private partner takes care of the pre-financing, construction and sometimes the operation of public infrastructure, receiving predetermined payments from the state. Alongside the provision of funds by the private sector which enables the project to be funded, such projects may be run more efficiently by the private sector and enter operation more quickly than where funds are from the public sector – in this sense they qualify as IFIs not only by (i) - providing extra funding for SD, but also by (ii) - ensuring shorter delivery times and reducing costs. While this model is not widely used, there is considerable potential for it be employed more - capacity constraints in terms of limits on recipients’ ability to negotiate fair terms and retain them over the duration of the contract with the private partner need to be addressed fully and transparently for this to be realised.

Catastrophe insurance provides another example of reducing costs. Based on accurate measurement and spreading of risk, it can lead to major savings on premiums and ensure immediate payouts after a disaster. It is also likely to encourage additional investment for SD by the domestic and international investors, thus helping with providing extra funds for SD too.

These and other IFIs, along with overview of financiers, markets and financing needs, policy issues, and legal, institutional and procedural questions are reviewed in more detail in Chapter 4 of this report.

Advance Market Commitments (AMCs) are an instrument that was developed to find suitable and affordable vaccine for pneumococcal diseases. The AMCs concept is to combine market instruments and public financing. The mechanism works as follows: the donors commit upfront to buy vaccines at a set price, and the manufacturing companies receive the funds from the AMC as a top-up, and continue to provide vaccines to poor countries at a set price for a certain time period after the funds exhaust.

Financial institutions and facilities clearly play major role in developing, providing and managing innovative financial instruments. Some of the key players in this field are the development Finance Institutions (DFIs), such as The World Bank, regional development banks (for example, Asian Development Bank), the European Investment Bank (EIB), Netherlands Development Finance Company (FMO), German Investment Corporation (DEG), and French Investment and Promotion Company for Economic Cooperation (Proparco). It is also important to underline the growing role of the Green Climate Fund (GCF) deriving directly from the UNFCCC: its objective is to achieve the transfer of funds from the most advanced countries to the most vulnerable ones to set up ambitious projects to combat the effects of climate change. Its policy lies on the promotion in each country of one or several independent Accredited Entities which will have the responsibility to organize the financing (grants, loans, guarantees) of climate resilient infrastructure projects.

The main financial instruments used by these DFIs are presented in Table 3. Besides, other institutions actively shape the landscape of development finance, such as NGOs (for example, WWF, or Conservation International), UNITAID, International Finance Facility, The Global Fund to Fight AIDS, Tuberculosis and Malaria, International Finance Facility for Immunization, GAVI Alliance, Global Health Investment Fund, etc.

Table 3: Financial instruments used by selected DFIs

DFI	Loans	Equity	Other (including technical assistance)
IFC	<ul style="list-style-type: none"> ▪ Loans & syndicated loans ▪ Blended loans 	<ul style="list-style-type: none"> ▪ Equity ▪ Structured finance ▪ Private equity & investment funds 	<ul style="list-style-type: none"> ▪ Risk management ▪ Trade finance (guarantees) ▪ Advisory services
EIB	<ul style="list-style-type: none"> ▪ Loans (senior, subordinated) ▪ Blended loans ▪ Mezzanine debt 	<ul style="list-style-type: none"> ▪ Equity Funds ▪ Venture capital 	<ul style="list-style-type: none"> ▪ Guarantees Derivatives ▪ Project bonds ▪ Advisory services
ADB	<ul style="list-style-type: none"> ▪ Loans (hard and local currency, senior and subordinated) ▪ B-Loans ▪ Mezzanine loans 	<ul style="list-style-type: none"> ▪ Equity (common shares, preferred stock, convertibles) ▪ Private equity funds 	<ul style="list-style-type: none"> ▪ Guarantees ▪ Technical assistance
FMO	<ul style="list-style-type: none"> ▪ Direct & syndicated loans ▪ Local currency loans 	<ul style="list-style-type: none"> ▪ Private equity ▪ Investment funds ▪ Mezzanine equity 	<ul style="list-style-type: none"> ▪ Guarantees ▪ Capital markets (securitisations) ▪ Mezzanine ▪ Trade finance
DEG	<ul style="list-style-type: none"> ▪ Long-term loans (fixed and variable rates) ▪ Mezzanine loans 	<ul style="list-style-type: none"> ▪ Equity ▪ Mezzanine equity 	<ul style="list-style-type: none"> ▪ Advisory services, technical assistance & feasibility studies ▪ PPPs with German/EU companies ▪ Guarantees
Proparco	<ul style="list-style-type: none"> ▪ Loans (senior, and subordinated debt) 	<ul style="list-style-type: none"> ▪ Equity ▪ Investment funds ▪ Quasi-equity (shareholder current accounts, participating loans, mezzanine) 	<ul style="list-style-type: none"> ▪ Guarantees (bond guarantees, bank loan guarantees, local currency loan guarantees, liquidity guarantee of mutual funds)
GCF	<ul style="list-style-type: none"> ▪ Subsidized loans 	<ul style="list-style-type: none"> ▪ Grants, Project Preparation facility scheme 	<ul style="list-style-type: none"> ▪ Readiness programme facility, National Adaptation Plan,

Source: Eurodad, “Private Finance for Development Unravelled,” URL: <http://www.eurodad.org/files/pdf/53bebd93dbc6.pdf>

The World Bank (WB) plays a leading role as a financial institution supporting innovative financing. The major initiatives and instruments that the WB is administering are presented in Figure 4.

UNITAID, another example of an innovative finance institution, is an organization founded in 2006 in order to fund the research of new drugs, produce data to support their use, allow more affordable generic medicine in low- and middle-income countries, speed up the availability and delivery of essential drugs. The major way of financing is through a tax on airline tickets currently in effect in 10 countries. Such financing scheme raises sustainable and predictable sums, which is essential for the organization’s operation in developing markets.

The Global Fund to Fight AIDS, Tuberculosis and Malaria, launched in 2007, is using an innovative instrument Debt2Health, which helps to channel resources to developing countries with high levels of debt and high disease burdens. This initiative involves asking the creditors of selected

beneficiary countries to forgive some portions of debt in exchange for the beneficiary governments reinvesting this portion of credit into programs through Global Fund.

Figure 4: World Bank Group Initiatives in Innovative Finance

Generating additional funds	Making funds more efficient	Linking funds to results
<ul style="list-style-type: none"> • Programs to reduce carbon emissions • The Adaptation Fund (AF) • Funds from emerging sovereign donors • Public-Private Partnerships (PPPs) 	<ul style="list-style-type: none"> • The International Finance Facility for Immunisation (IFFIm) • Local-currency bonds • Guarantee instruments • Instruments that mitigate farmers' risks • Instruments that mitigate country risks from natural disasters 	<ul style="list-style-type: none"> • The Advance Market Commitment (AMC) for vaccines • Results-Based Financing (RBF)

Source: World Bank, "Innovative Finance for Development Solutions," URL: <http://siteresources.worldbank.org/CFPEXT/Resources/IF-for-Development-Solutions.pdf>

The GAVI Alliance (known also as Global Alliance for Vaccines and Immunization), established in 2000 as a public-private partnership, focuses the resources of governments and vaccine manufacturers to boost immunization of the world's poorest countries. The International Finance Facility for Immunization (IFFIm) is an innovative finance instrument, by which future streams of development assistance from donor countries (over a 30-year time horizon) would be frontloaded to the present. The IFFIm is a facility that deals specifically with the GAVI alliance, however, similar principles of International Finance Facility (IFF) are exercised in other areas. This mechanism requires donors to underpin the issuance of bonds in the international capital markets in order to leverage resources for immediate development assistance.

The Global Health Investment Fund (GHIF), established in 2013, has mobilized resources from high-net-worth individuals, foundations, institutional investors, strategic investors, and government-backed funds in the form of government and private guarantees to leverage private investment for research for new vaccines.

Overall, some innovative mechanisms require a separate facility or an organization, managing this particular instrument (e.g. UNITAID), while others could be administered by existing institutions (e.g. World Bank's initiatives), depending on the nature and purpose of an instrument.

4 IMPLICATIONS FOR LOT 6

Innovative finance has become an important category of development finance in the recent years. Expanding coverage and usage of innovative finance instruments justifies the necessity to provide thorough and detailed investigation into the nature of these tools, their applicability, issues surrounding their use, and the impact assessment. Many of the important issues regarding innovative finance have been laid out in the technical description of Lot 6. This chapter provides a critical analytical discussion about each item identified in the document.

4.1 Overview of products and structures

Section 3 provided a brief discussion of available innovative finance instruments, and various institutions and facilities that service them. However, it is essential to analyse the products and structures in-depth, contextualizing and providing brief examples for different instruments listed in Lot 6. Clearly, each instrument is used for different purposes, and has its own advantages and shortcomings. This chapter, therefore, provides a detailed analytical insight into the nature of various innovative finance instruments.

Structured Funds

Development finance instruments, although serving distinct purposes, can be technically similar to financial mechanisms used in commercial transactions. A case in point is the usage of structured funds, which belong to a wide category of market-linked investments based on derivatives. While in commercial activities those are created to meet the specific market needs that cannot be met through standardized financial instruments, in development finance structured funds are performing a risk-diminishing function, and are a way to finance micro-loan institutions. In particular, as mentioned above, the risk is structured in tranches, and distributed accordingly to provide principle guarantee of protection against non-performing loans.

Several institutions are providing development finance in the form of structured funds, among others are the International Finance Corporation (IFC) of the World Bank Group, The German Development Bank (KfW), and a subsidiary of the French Development Agency (AFD Proparco).

The IFC – owning a triple-A credit rating – is operating in developing countries to provide long-term local currency solutions and access to local capital markets through structured products. The primary focus on mobilizing local currency through local financial markets is serving a purpose of reducing or eliminating the exchange rate risk associated with borrowing in foreign currency⁴. This way the IFC issues structured products to microfinance clients and small and medium size enterprises. The IFC has carried out a total of 182 structured finance transactions in 46 different countries⁵.

As an example of IFC's work, in Bangladesh, almost 1,200 NGOs are providing microcredit in around 40,000 villages, where half of the population lives below the poverty line. With donor support for microfinance institutions gradually exhausting, the structured fund was established by the IFC in partnership with Citibank. The IFC partially guaranteed a local currency loan from the Citibank to one of the largest microfinance institutions (BRAC) to guarantee the continuation of microlending in Bangladesh. Similar guarantee partnership transactions in local currencies were established by the IFC in Mexico, Peru, Morocco, Jordan, Tunisia and Madagascar⁶.

The KfW, for example, has provided structured products to such funds as Aavishkaar's India Impact Fund and the Microfinance Initiative for Asia (MiFA) Debt Fund, which are the institutions

⁴ The IFC, Structured Products, URL:

<http://www.ifc.org/wps/wcm/connect/51eed100487c9a249cd4bd84d70e82a9/VPU+localcurrencybrochure+5-08.pdf?MOD=AJPERES>

⁵ The IFC, Structured Products, Past Transactions, URL:

http://www.ifc.org/wps/wcm/connect/Topics_Ext_Content/IFC_External_Corporate_Site/Structured+Finance/Past+transactions/

⁶ The IFC, "IFC and Local Currency Financing," URL:

<http://www.ifc.org/wps/wcm/connect/51eed100487c9a249cd4bd84d70e82a9/VPU+localcurrencybrochure+5-08.pdf?MOD=AJPERES>

that mobilize microfinance in Asia⁷. Similarly, AFD Proparco provided support to Albaraka, Morocco's 3rd largest microfinance institution⁸.

Although structured funds are able to ensure principal protection, reduce risks and provide more resources to microfinance institutions, they have a number of drawbacks. First, the credit risk, although restructured into different tranches, is still present. This requires financial institutions to conduct regular and thorough risk-assessment, especially considering that microloans are provided in low-income and high-risk countries. Second, structured products lack liquidity, whereby even the senior tranche is relatively difficult to sell in the secondary market before its maturity. Third, structured products tend to be highly complex, which requires a managing authority to have considerable expertise to working with such products.

Project Finance and Public-Private Partnerships

In project finance, lenders and investors rely on the cash flow generated by the project (i.e. feed in tariffs in the energy sector, tolls in the road sector, etc.) to repay the loans and earn a return on investments, as opposed to relying on balance sheets of the sponsors in case of traditional loans. Usually project finance involves long-term financing of infrastructure or industrial projects, and can be financed either exclusively ("non-recourse" financing) or primarily ("limited recourse" financing) through project's cash flow. The structure of project finance is highly complex and varies according to specific project. It involves a number of equity investors (sponsors/developers) and lending institutions which provide loans (banks or a syndicate of banks).

Public-Private Partnerships (PPPs) are generally financed using project finance arrangements. Some important features of the project finance and PPP structures include the following. First, it should be designed to optimise the costs of finance for the project. Second, the financial and other risks should be carefully allocated within a PPP project in a way that those are managed accordingly within and between the PPP Company shareholders, sponsors and financiers. Third, a project finance arrangement has to be well-balanced in term of long-term robustness. For example, if a project has high debt-to-equity ratio, during an economic turmoil or in case of increased instability, the risks of loan default and project termination are higher.

Project finance and PPPs are used in both developed and developing countries to increase the efficiency of finance in infrastructure-related projects, and as a form of development arrangements in developing and least developed countries. As mentioned, the projects vary considerably, depending on purpose, type, timeline, complexity, country of origin, nature of sponsors, etc. A collection of case studies for project finance for infrastructure in Africa can be found here: https://www.imf.org/external/np/seminars/eng/2014/CMR/pdf/Dornel_ENG.pdf. Apart from banks, financial associations and various financial institutions, there are actors that are enabling successful PPPs, such as, for example, The International Project Finance Association (IPFA). This NGO is representing the interests of both public and private sector organizations, and deals with the key players within the infrastructure and energy industry, such as financial institutions, construction companies, project sponsors, etc. IPFA operates worldwide and is collaborating with over 600 members to organize events and assist in carrying out projects.

⁷ Subject paper of the International Development Working Group, UK's Presidency of the G8, URL: <http://www.socialimpactinvestment.org/reports/International%20Development%20WG%20paper%20FINAL.pdf>

⁸ AFD Proparco, URL: http://www.proparco.fr/lang/en/Accueil_PROPARGO/Actus-Events-Proparco/News_PROPARGO?actuCtnId=127717

PPPs, as a non-traditional instrument of development finance, is believed to deliver better infrastructure solutions, and stimulate faster project completions. Besides, one of the benefits of PPPs is that, complimented by private finance, it allows the governments to redirect funds to other important socio-economic issues or reduce budget deficit. On the other hand, every PPP involves risks for private institutions, and those are usually compensated, which, in turn, can increase government's costs. In addition, the government in PPP projects may be at a disadvantage if the expertise in the partnership relies heavily on the private participant (for example, a government lacks capacity to analyse and assess the costs and the fair balance of the risks between the private operator and the country).

Corporate Finance

Corporate finance is a very broad category of financial instruments, often referring to activities that deal with company's finances and capital, or with transactions in which capital is raised in order to create, acquire or develop businesses. These activities can include start-ups, development or expansion of capital, mergers, acquisitions, takeovers, buy-outs, equity issues, etc. From the perspective of economic development goals, corporate finance is aimed at supporting medium to large-scale sustainable private sector projects.

An example of corporate finance for development purposes can be represented by the Structured and Corporate Finance Department (SCF) of the Inter-American Development Bank (IDB) Group. SCF performs non-sovereign operations for infrastructure projects, financial institutions, capital markets, companies, and state-owned enterprises in Latin America and the Caribbean. The role of SCF is to mobilize resources from third parties, such as commercial banks, institutional investors and go-guarantors. SCF is mainly a catalyst, providing partial credit guarantees for the projects, supplying tailor-made medium and long-term direct loans and technical assistance in the form of non-reimbursable financing for large companies.

SCF finances 25-40% of the total cost of a project, and the amount limit is set to \$200 million (in exceptional circumstances this amount can reach \$400 million). Technical assistance part can account for \$100,000 and \$1.5 million. SCF has exercised their corporate finance operations in such sectors as energy, transport, water and sanitations, sustainable natural resources, healthcare, education, and tourism.

Corporate finance is not generally considered to be a wide-spread instrument in development financing. In this regard, it can be assumed to have a big potential for the expansion of its use, on the other hand, however, the possible shortcomings are not yet well explored. The major threats are coming, naturally, from the model of risk sharing regarding individual projects.

Micro, Small & Medium Enterprises Finance

While large infrastructural projects are undoubtedly important for development, small businesses are collectively the largest employer in many developing countries. However, according to World Bank's Enterprise Surveys, Micro, Small and Medium Enterprises (MSMEs) are more likely to have limited access to capital, thus preventing them from growing and enhancing productivity. The focus of development finance on MSMEs through providing access to credit, equity and payment services, can help to boost job creating, raise income and stimulate economic growth. The objective of MSME finance, therefore, is to improve access of MSMEs to finance and business development services.

The World Bank is a leading international institution that provides expertise and assistance for MSMEs. Along with the International Financial Corporation, the Consultative Group to Assist the Poor (CGAP), and the Alliance for Financial Inclusion (AFI), the World Bank is a partner for implementing the G20 Global Partnership for Financial Inclusion (GPFI). Other institutions dealing with MSME finance include, among others, the regional development banks, the UNCDF, the OECD, Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ), United States Agency for International Development (USAID), Australian Agency for International Development (AusAID), Switzerland's State Secretariat for Economic Affairs (SECO).

The World Bank uses data and analysis, financing and risk-sharing, and technical assistance and capacity building as major instruments to meet the challenges of MSME finance. The main lending tools are the Development Policy Loans (DPLs) which incorporate a series of reforms or actions that the borrower must carry out; and investment loans with special credit lines for MSMEs or with support through credit guarantees to encourage financial institutions to lend to MSMEs. In addition, in 2013 the World Bank established Financial Inclusion Support Framework (FISF) through which it committed to help 10 IDA countries to reach their financial inclusion goals. Technical assistance is provided by the World Bank in more than 100 countries, and is aimed at supplying expertise to carry out institutional and policy reforms.

Some country examples of WB's MSME finance include Turkey, where in order to expand export capacity of SMEs, the World Bank allocated \$1.7 billion. According to an evaluation, the participating exporting firms grew more quickly in terms of volumes of exports, sales and employment⁹. In Nigeria \$5.7 million was provided by the World Bank to establish a commercial microfinance industry.

Given the significance of small businesses for developing countries, MSME finance is an important tool to provide innovative solutions for economic growth and poverty reduction. However, provision of MSME finance in reality faces a number of obstacles. First, size of companies implies that there is lack of collateral that puts financing institutions at a risk. In addition, there is little availability of long-term credits, as those are usually associated with bigger and more profitable businesses.

Equity, quasi-equity, mezzanine finance products

Compared to pure debt instruments, equity finance can provide higher potential returns. However, acquiring equity in development finance may pose significant risks of insolvency for financial institutions or other potential investors. Quasi-equity (also referred to as mezzanine finance) is a hybrid form of investment that combines the characteristics of debt and equity, and the specific facility can be tailored to suit the preferences of risk-reward ratios of the participating investors. Those preferences are supported by different forms of mezzanine finance, such as (listed in terms of increasing risk-reward ratio) subordinated debt, convertible debt, and preferred equity.

Financial institutions, such as the IFC, Asian Development Bank, German Investment Corporation, and ADF Proparco have committed financial resources in the form of equity (an estimated 16% of all funds¹⁰) and quasi-equity. In the fiscal year of 2016, the IFC, for example accounted for about \$2.6 billion of commitments in equity. The share of IFC in a company's equity is usually ranging between 5% and 20%. Other institutions, such as, for example, the Norwegian

⁹ The World Bank, MSME Finance, URL: <http://www.worldbank.org/en/results/2013/04/05/msme-finance-expanding-opportunities-and-creating-jobs>

¹⁰ Eurodad, "Private Finance for Development Unravelling". <http://www.eurodad.org/files/pdf/53bebdce93dbc6.pdf>

Investment Fund for Developing countries (Norfund) uses equity and quasi-equity finance (10-35% of the funding) directly in companies and financial institutions, and indirectly through local and regional investment funds.

While equity and quasi-equity finance has certain advantages compared to loan-based instruments (higher returns, addressing specific risk capacity constraints, stimulating additional investment), there are certain shortcomings. First, these investments are more difficult to administer, they are more time-consuming, and more expensive. Second, this type of finance is only possible to provide on a long-term basis. Third, compared to debt instruments, equity and quasi-equity finance can be less attractive to investors due to the obligation to exercise control.

Guarantee, insurance, and other risk sharing mechanism

Guarantees – which are used as a type of insurance – are a frequently used financial instrument. Guarantees protect banks and investors from risks of non-payment, i.e. they do not involve any direct payment unless in the case of borrower's default. In development finance, guarantee schemes are used specifically to support projects that aim at promoting economic development and increase welfare. Guarantees make lending more attractive since they help to diminish risks associated with a particular project. They are therefore a tool to mobilize resources from private companies, banks, investment funds, etc.

There are various types of guarantees depending on policy objectives. For example, some institutions, such as IFC and Dutch Development Bank (FMO) are focusing on trade-related instruments; other forms of guarantees can be issued to assist finance access for SMEs (acting as a form of collateral), to support low-income households' mortgages and other loans, to promote green investment, etc. Besides, guarantees can be divided into project-based and policy-based.

The major providers of guarantees are the International Bank for Reconstruction and Development (IBRD) and International Development Association (IDA), IFC, Multilateral Investment Guarantee Agency (MIGA), regional development banks (ADB, IADB, AfDB), and USAID. Some developing countries have established their own guarantee schemes, for example, the Nigeria Agricultural Credit Guarantee Scheme Fund which focuses on agricultural SME credits; or the China Utility-Based Energy Efficiency Finance Program to promote investment in renewable energy sectors.

The main advantage of guarantees is their feature of reducing risks and potential losses, as well as improving the credit quality of project. For the governments of receiver countries guarantees benefit by requiring less funding than loan programs. A negative feature of guarantees is that they represent a liability to the issuer, which can risk the low sustainability of its debt. Additionally, guarantees can pose the problem of moral hazard, whereby protection from losses provided by a guarantee may encourage lenders to lower their lending criteria, thus leading to higher default rates.

Risk-Related Financial Structures

Dealing with risks is a cross-cutting issue in development finance, its complexity varies significantly depending on the nature of project or financing arrangement, geographical scope and application, types and number of participants involved, etc. A broad range of possible risks makes risk analysis and assessment an important prerequisite to starting a project or applying a financial tool. In turn, many financial instruments described in this chapter are aimed, among other functions, at bearing certain risks. For example, structured funds or insurance are a way to share the risks.

Compared to usual commercial transactions, development finance can be exposed to a larger number of risks. Political, social and policy risks (for example, related to public and private governance, legal ownership rights) are originating from the social dimension, including governments and individuals. Technical and physical risks (for example, related to construction, environmental impacts, operation and management, disaster and catastrophe) are derived from the physical dimension of assets and environment. Commercial and market risks (such as currency exchange risks, price volatility, access to capital, investment liquidity) cover economic environment-related issues. Risks related to outcomes (for example, employment and other co-impacts, financial sustainability) are related to achieving public policy and budget objectives.

Given this complex potential risk structure, risk assessment approaches must reflect a good understanding and analysis of these issues, and address each type of risk according to a prioritized hierarchy. Such tasks require elaborate modeling tools, deep expertise and experience. For this reason, risk assessment and analysis is typically carried out by specialized institutions, agencies, or consultancies.

As mentioned, some financial instruments provide a build-in risk mitigation or risk-sharing function. Risk financing implies the retention of risk and the adoption of a financing strategy in order to ensure that funds are available to meet the needs in case of the realization of the risk (for example, a natural disaster). These instruments include the accumulation of separate funds obtained in advance from credit facilities or investment funds. Most instruments, however, enable risk-sharing (or risk transfer), i.e. shifting the risks to other agents, who agree to bear it in exchange for higher potential returns. Such instruments cover insurance policies, structured funds, catastrophe bonds, risk tranching and waterfall mechanisms (financing models where loan tranches are structured according to risks). For example, PPP projects related to infrastructure development are usually established in the form of Special Purpose Vehicles (SPVs) which help to protect the private sponsor's balance sheet from project risk.

Given this discussion, it is clear that risk-related financial structures and services are offered by a wide variety of financial institutions, specialized private and public companies and agencies. All the institutions of the World Bank Group (IBRD, MIGA, IDA and IFC) include risk-mitigation in their operating mandates. Regional development banks and non-government organizations are also involved in providing risk assessment services. Finally, depending on the nature of financial operation (which is particularly important for project finance) participating actors are involved into risk management to provide self-sustainable finance solutions.

Local currency finance

Foreign exchange risk can pose significant hurdles to development finance. For this reason, facilitating local currency financing is an important development objective. In fact, local currency finance is not a separate instrument, some of the instruments discussed in this chapter can be simply provided in local currency: loans, bonds MSME finance, structured funds, swaps, etc.

Local currency loans, for example, are particularly important for SME finance, since small businesses might not be capable to repay the debt in case of significant exchange rate fluctuations. By using local currency loans, the exchange risk is fully transferred to the lender. The latter, however, can more easily diversify the risks by lending in different countries, as well as securing itself through other financial market instruments. Local currency swaps is another tool that helps actors to transform existing or new foreign currency liabilities into local currency.

The IFC – one of the most important international institutions to provide local currency finance – does so through a variety of instruments: local currency loans, synthetic local currency loans, structured finance and quasi-equity. As well as that, IFC mobilizes other sources of local currency (such as local banks and investors) through financial markets. Some prominent examples of IFC’s activity in providing local currency finance include healthcare project in Nigeria (a loan to Hygeia Nigeria Limited); modernizing electricity distribution in Brazil; financing energy efficiency projects in China¹¹. Another example is the German Development Bank (KfW), which established a program to promote local capital markets and microfinance institutions in Africa (Local Currency Fund).

The major disadvantage of local finance instruments is that funds providers often use derivatives (such as swaps), which may contribute to increased volatility of local currency exchange rate. Another concern is that existing mechanisms are highly fragmented (and sometimes not transparent), and mostly rely on limited financing. Besides, as mentioned above, the lender bears significant risk, thus requiring a substantial degree of diversification.

Disaster risk reduction finance mechanism, resilience enhancing mechanisms

The consequences of natural and human-made disasters in developing countries tend to be costlier¹², with hydrometeorological accidents (such as floods or droughts) causing around 90% of the damage¹³. While ex-post relief and recovery measures are important, a part of the finance should be transferred as a fund prior to a disaster, since that money can be used more quickly and efficiently in case of an accident. There are various instruments of ex-ante finance, such as reserves, insurance, contingent credit facilities, and catastrophe-linked securities. The example of the latter is the World Bank Catastrophe Deferred Drawdown Options (CAT DDO loans), which are aimed at supplying immediate liquidity to the disaster-affected regions.

Limited ability to pay insurance premium in developing countries makes catastrophe risk finance assistance an important area for development finance. Local insurance markets are extremely underdeveloped: for comparison, in developed countries more than 40% of the loss from natural disasters is insured, while this figure stands at around 10% for middle-income countries, and at less than 5% for low-income countries¹⁴.

The World Bank has established a number of national insurance pools and regional insurance pools for private property catastrophe insurance in developing countries. One of the first was the Turkish Catastrophe Insurance Pool (TCIP), which transferred earthquake risk to international reinsurance markets. In 2007 the WB has helped to established Caribbean Catastrophe Risk Insurance Facility (CCRIF) which offers insurance with payouts based on an index (for example, measuring earthquake data or hurricane wind speeds) as a proxy for the actual loss. By pooling resources of the 16 countries, the CCRIF manages to provide immediate relief after a disaster, such as \$7.75 million payment to Haiti after an earthquake. Some other developing countries, such as China, Colombia, India, Iran, and the Philippines have established their own disaster insurance programs with the support of the World Bank. Some insurance pools are targeted at specific problems, such

¹¹ International Finance Corporation, “IFC and Local Currency Financing,” URL: <https://www.ifc.org/wps/wcm/connect/51eed100487c9a249cd4bd84d70e82a9/VPU+localcurrencybrochure+5-08.pdf?MOD=AJPERES>

¹² PPIAF (Public-Private Infrastructure Advisory Facility). 2008 Annual Report. Washington, DC: World Bank

¹³ Navin Girishankar (2009), “Innovating Development Finance,” URL: http://siteresources.worldbank.org/CFPEXT/Resources/CFP_Working_Paper_No1.pdf

¹⁴ Cummins, J. David, and Olivier Mahul. 2008. Catastrophe Risk Financing in Developing Countries: Principles for Public Intervention. Washington, DC: World Bank.

as protecting farmers and herders against weather-related shocks. A case in point of an agricultural-related instrument is the Mongolia's Livestock Insurance Indemnity Pool, which protects farmers against high livestock mortality rates due to extreme winter temperatures or draughts.

The obvious drawback of using ex-ante financial tools is their high opportunity cost. As well as that, in the case of insurance, the payment may not be immediately available. In addition, the pricing of insurance is subject to fluctuations in the world insurance markets.

Bonds and securitisation

Securitization implies ensuring future payments through the assignment of future cash flows, i.e. future incomes from a project for which the funds are raised. Bonds are an innovative instrument when used in development finance, since the new types of bonds link the resource mobilization with development objectives – economic performance or environment-related issues.

Performance-based bonds (for example, counter-cyclical or GDP-indexed bonds) are an instrument that seeks to ease the debt burden for developing countries by reducing repayments in bad periods and increasing them in good. The approach was developed by the AfD (The French Development Bank) with the purpose to avoid debt spirals and reduce risks of default. These instruments can be used in countries with relatively stable economic situations, where the potential to mobilize funds is high. Despite having a lot of potential, so far the instrument has not been particularly attractive to potential lenders, given the difficulties of calculating the repayment streams and the instability of financial flows.

Another example of innovative use of securitization is “Ethical Bonds” and “Diaspora Bonds”, which help to mobilize private funding to assist development processes. The main feature of these instruments is that, while still targeting positive return, they accept a reduction in the level of return due to the goals of achieving economic and social development objectives, which normally require higher expenditure compared to purely commercial projects. “Diaspora bonds”, for example, are enabling the citizens of developing and emerging countries who live abroad to provide funds to their homeland. Given the attachment investors have to their local societies, they are prepared to forego a part of profits, and are not withdrawing their funds immediately in the case of economic instability. Such funds are a popular instrument for countries with strong diaspora ties, such as India or China.

Ethical funds are also provided by the World Bank in the form of “Green Bonds” and “Cool Bonds,” which target environmental domain and climate-related projects accordingly. The only difference of green bonds from conventional bonds is their exclusive use for projects related to climate change adaptation, renewable energy (solar, wind, biomass, mini-hydro), energy efficiency and renewable use promotion, sustainable waste management, biodiversity, forestry and carbon sequestration, clean transportations, clean water and sanitation, etc. The examples include Johannesburg where green bonds were issued to finance emission-reducing projects, development of biogas energy, solar power and sustainable transportation. In Mexico a state-owned development bank issued green bonds to finance nine wind energy projects. The World Bank manages an entire portfolio of green bonds in middle-income countries. In addition to climate resiliency, social, gender and minority factors should also, as far as possible, be accounted when developing and promoting ethical projects seeking for financing.

Ethical funds, including the abovementioned types of bonds, are currently being underused, however, they have a big potential for development. The main challenge to increase the use of this instrument is to design finance schemes that would encourage potential investors to forego a part

of their profits to achieve development objectives. As mentioned before, regardless of the type of bonds, a cross-cutting feature of the bonds can be their issuance in local currency.

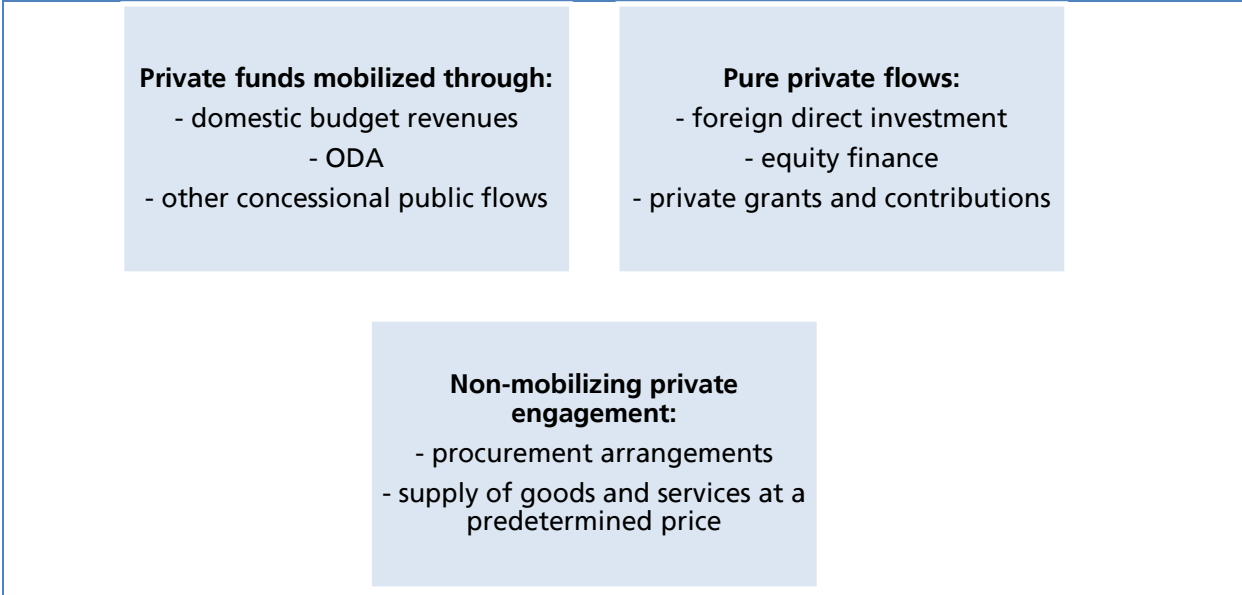
4.2 Overview of Financiers

One of the goals of innovative financing is to align the incentives and strategic objectives of various actors, including financial institutions, international development agencies, multinational corporations, and private businesses and foundations – to assist development objectives. Financiers in development are on average bearing more risk than in most commercial transactions due to the nature of their investment. Therefore, collaboration between different types of financiers, both from public and private sector, may channel more resources to development in a more efficient way, while creating a better risk-sharing distribution.

Private sector investors play an increasingly important role in development finance. Its important feature is that private commercial funding seeks for a market-valued rate of return, as opposed to public financiers who are able to forego a part of a profit and accept lower-than-market rates of return to achieve social objectives. Specifically, if a private investor is deploying money in factories and machinery, the financial return generated from such an investment should be larger than the risk-adjusted cost of the capital. In other words, social returns are usually not taken into account by private financiers. From a policy perspective, this dictates the necessity to create conditions which would incentivize private investors to participate in development projects.

The relative importance of private finance in development depends on the type of private sector engagement (see Figure 5).

Figure 5: Forms of Private Sector Engagement in Development Assistance



Private funds mobilized through government domestic tax and non-tax revenues (domestic budget revenues), Official Development Assistance (ODA) and other concessional international public flows (such as loans by development banks, development finance institutions, public guarantees, insurance and export credits) are mobilizing resources for specific projects. The second type is pure commercial finance, such as foreign direct investment, which may not target development projects per se. Its impact on achieving sustainable development goals is harder to quantify. However, compared to the official flows, the two categories collectively represent a large share of

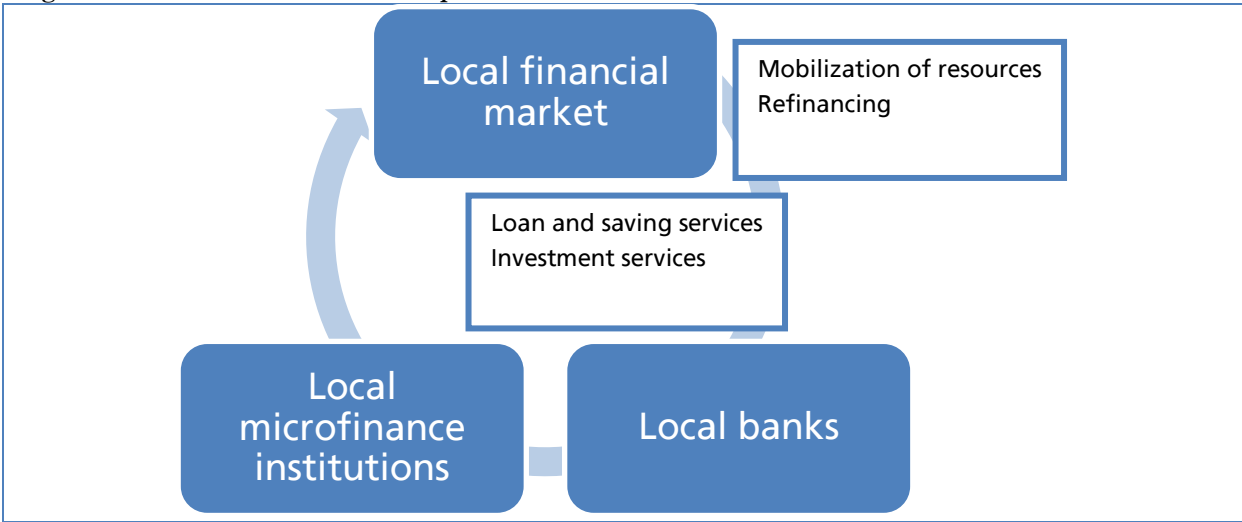
development finance. Within each category, private finance can be further divided into international, domestic and local investment.

There are other possible forms of engagement of private companies to assist development. For example, Advanced Market Commitments (AMCs) discussed in chapter 3, ensure the participation of private companies in certain procurement arrangements. Under AMCs public institutions can agree to purchase a good or a service from a private provider and a predetermined price. Such schemes are used to purchase important medicines and vaccines for developing countries.

Innovative financing mechanisms bring benefits to private sector investors. First, they have created new channels for private actors to allocate capital to support development and create better business environments. Besides, innovative tools open new market opportunities and offer the private sector risk-adjusted financial returns in areas where before the investment seemed infeasible. Guarantees, for example, facilitate investment in new markets, while performance based-contracts provide an opportunity for private companies to sell their goods and services in new markets. A mix of public and private finance (in the form of PPP or blended finance instruments) similarly creates business opportunities for private companies.

Local financial markets, banks and microfinance institutions are also important participants in innovative finance mechanisms for development. They often act as intermediaries for other actors, such as public institutions and private companies. With limited capacity to operate directly in developing countries for foreign agents, local institutions facilitate creation and distributions of value. Besides, they operate close to their clients and embrace local culture and traditions thus promoting more trust. Another important advantage of local actors is that their operations are carried out in local currencies, partially mitigating the risk of exchange rate fluctuations. The major challenge is that the level of development of local institutions in low-income countries is often significantly lagging behind the one that would be implied by their importance in the processes of development.

Figure 6. Local Institutions in Development Finance.



In particular, financial markets represent an important platform to refinance other institutions. As in structured finance, for example, tranching risk-bearing products are harder to sell in secondary markets, and with high market density it is very unlikely. Development of local financial market for secondary financial tools can help to redistribute risks at a local level. The World Bank Group together with regional development banks is providing technical assistance for the development of local financial markets.

The development of local banks is crucial for efficient operation of other market institutions. Particularly, the provision of loans in local currency to small and medium businesses can help to achieve development objectives. The loans provision should be underpinned by trust-building policies and stability of local banking system, which stimulate savings flows and better funds management.

Microfinance institutions, similarly, are the ones operating in the field, and dealing closely with the population. Their goal is to fill the gaps in financial services by offering small or micro loans to people who are unable to access conventional loan services. Microfinance institutions also provide saving services and act as extensions of investment banks. A key instrument to enhance creditworthiness, local microfinance institutions, therefore, play an important role in the development of rural and remote poor areas.

Export Credit Agencies (ECA) are another type of financiers, which can be established as a private, quasi-governmental or public institution to issue export financing and act as an investment insurance agency. Credits, credit insurance and guarantees are the main financial instruments used by the ECAs. By underwriting business activity abroad, ECAs play a major role in project finance in developing countries and provide insurance for foreign direct investment there.

ECAs provide financial assistance to importing entities. It can come in the form of direct lending, whereby the loan is conditioned upon the purchase of goods and services from the loan originating country. Loans by ECAs can also be provided through financial intermediaries, such as commercial banks. In addition, ECAs can ensure that a commercial lender will provide a loan to the importing entity at below market interest rates (interest rate equalization), while the intermediary receives a compensation from the ECA. Recently ECAs have emerged as leading players in project finance, since they can lower the risk of private lending by providing export credit guarantees. This is particularly important for large infrastructural projects which are highly capital intensive and risky. For example, collectively, ECAs are among the largest global sources of public financing and guarantees for fossil fuel projects.

While financial markets and banking sector are essential for economic development, there are some functions that can be fulfilled only through **insurance industry** operations. By improving the investment climate and promoting more efficient mix of activities through mitigating risks, insurance products are complementary to banking and financial system in contributing to economic growth. Insurance market affects the range of available investment alternatives and the quality of information needed for decision-making. For example, high risk of loss during transportation may require a company to limit its production to only local consumers, while using transport insurance may help to expand market access opportunities. In agricultural production, due to meteorological conditions, farmers risk losing a part of their crop, thus deciding to keep a high proportion of the seeds in reserves. Crop insurance in this case would compensate the risks of losing the crops and help to recover the opportunity cost of keeping excessive stock.

Thus, insurance providers play an important role in improving country's productivity. Some insurance tools are particularly important for middle and low-income countries. Household insurance, for example, is becoming more important with the development of micro-finance providers. Limited capacity of coping with natural disasters in developing countries makes catastrophe, weather and crop insurance another important instrument. With SMEs playing a major role in developing economies in terms of employment, insurance product tailored for small and medium enterprises also appear to be of high importance. Thus, one of the objectives of international institutions and fund providers should be the development of robust insurance

industry with a range of innovative finance instruments adapted to the needs of developing countries.

Institutional investors (such as pension funds and insurance companies) are becoming an increasingly important source of financing. The main feature of institutional investors is their pursuit of long-term inflation protected returns. A type of income that such funds are searching for can be found in real assets such as infrastructure. Thus, part of the infrastructure finance gap in developing economies can be addressed, among other funds, by institutional investors.

Traditionally, institutional investors have been viewed as sources of long-term capital with investment portfolios build around bonds and equities. Recently, however, there have been shifts in investment allocation with decline of the share of equities, while investments in bonds and alternative instruments have increased. Infrastructure investments are becoming more attractive to Sovereign Wealth Funds (SWFs) and Public Pension Reserve Funds (PPRFs) as these investments can generate attractive yields in excess of those obtained in the fixed income market, and can match the long duration of pension liabilities.

Thus, combined with the need of relatively economically stable developing countries for increased investment in infrastructural and other long-term development projects, institutional investors can earn a strong stance as providers of innovative finance development solutions.

4.3 Overview of Markets and Financing Needs

Development finance, and innovative finance in particular, aims at facilitating both public and private participation in order to support **core public functions** of governance and **private commercial goals**. Some actors in development finance explicitly focus on development as an overarching goal (governments, civil society organizations, NGOs, multilateral development institutions); some concentrate on the support for the efficient market operation as a link between development and financial profitability (for example, some multilateral and regional development institutions); and some are seeking to ensure secure business operations and access to new markets (private sector participants).

Traditionally, public policy objectives are interlinked with government action in the market, aimed at correcting market failures through provision of public goods (social services and infrastructure) and regulation. Development and enforcement of rules, resource reallocation, program implementations, facilitation of production and exchange are the important tools available to the governments to achieve stability and proper market functioning. Private finance, in turn, relates to private investment and interaction between private agents. Their primary goal is to maximize the use of economic resources to achieve market objectives. In doing so, private participants manage various risks and costs associated with agency problems and information asymmetries.

The goals of the private and public sectors are often aligned, especially when related to stabilizing and organizing positive market environments: governments are seeking for increased welfare for the population, while same phenomena brings more profits to the private companies. In this sense by supporting the collaboration between the two sectors of the economy, innovative financing instruments not only compliment the traditional international resource flows, but also facilitate the alignment of incentives, reinforcing the achievement of development objectives.

Government participation in stimulating development is important due to the presence of **market failures**. In economic theory, this term refers to inefficient allocation of resources, i.e. there exists

a possibility to reallocate resources such that some agent becomes strictly better-off, while others are not strictly worse-off as a result of this reallocation. The reasons for the misallocation are associated with such phenomena as non-competitive markets, information asymmetries, time-inconsistent preferences, externalities and principal-agent problems. Correcting the sources and the consequences of market failures is the primary rationale for government intervention.

In policy making the causes of market failures are not easy to identify, but the consequences reflect themselves in lack of cost-effective delivery of services, lack of facilities to manage and reallocate risk, and inefficient markets with high transaction costs. These issues can be addressed through breaking down and finding a niche to use a particular instrument. Innovative financing, compared to traditional instruments, can address specific market failures more precisely through resource mobilizations, financial intermediation and improved resource delivery. For example, mobilizing resources can support commercial sustainability of microfinance industry, which, in turn, provides market-based solutions to low-income population, or small and medium businesses that lack collateral. Financial intermediation addresses information asymmetries and agency problems through reallocating business risk. Finally, resource delivery can facilitate information sharing and dissemination of best practices, such as management innovations.

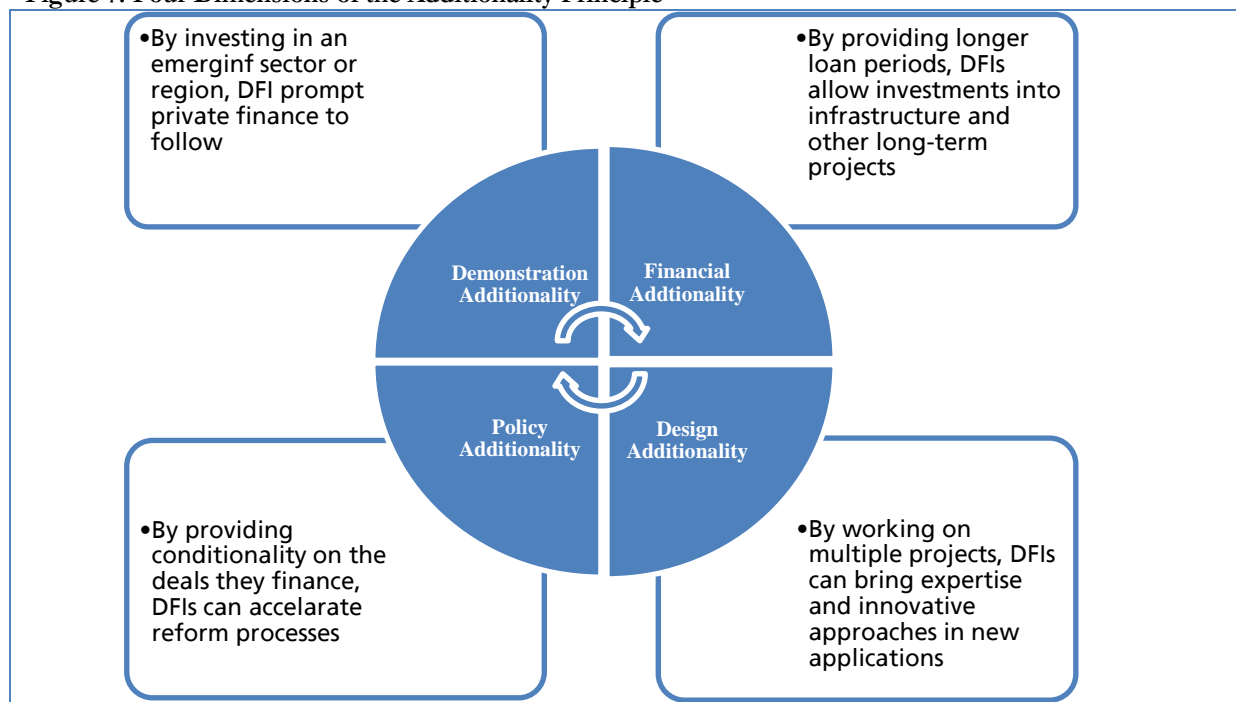
A good example of using innovative finance to correct a specific market failure is Advanced Market Commitments (AMCs). Global vaccine markets are unable to provide affordable vaccination to low-income countries, and the population of those countries, in turn, is unable to acquire the vaccines on market terms. Through AMCs, which combine the efforts of public and private sector, such a mismatch can be partially overcome. Another example is the Affordable Medicines Facility for malaria, - a financial system designed to make antimalarial treatments accessible through negotiating a reduced price to end-users.

Promoting development through fostering economic growth is seen as a prerequisite for poverty reduction and sustainable development. However, not every type of action that stimulates economic growth would have a positive effect on the recipient countries. In order to fully realize development objectives, two principles are essential:

- a) Additionality, i.e. development finance should be exclusively used to correct market failures.
- b) Catalytic effect, i.e. development finance should be used to reduce the risk for other market operators.

Additionality is a concept widely used in reference to development finance institutions (DFIs). It requires that DFIs ensure that development impact is the priority, and at the same time, development finance does not compete with private (local) sources of investment. In other words, development finance should avoid **crowding-out** of other investments, conversely, it should generate conditions to catalyse private investment deals that otherwise would not have taken place (**crowding-in**). Additionality is usually described in four dimensions: demonstration, finance, design, and policy (see Figure 7).

Figure 7: Four Dimensions of the Additionality Principle



Given the above discussion, the impact of development finance directly depends on the market structure and the alignment of participants' incentives. In projects where the expected returns exceed the cost of the project adjusted by risk premiums there is essentially no need for the public sector to get involved. In other words, if **financial and economic sustainability** of the project is high, there is no need for grant support from the public sector.

There are different approaches to plan, assess and evaluate development projects; some use rigorous computational and quantitative tools, some rely on narrative approach and case study analysis. The main criticism of the former is that it rarely suggests negative outcomes, and ignores many social, environmental and cultural issues. While providing a partial perspective, financial and economic analysis is still an important tool to provide clear guidance to decision-makers. The financial part of the analysis examines the activities and resource flows of individual entities, while the economic assessment focuses on flows of resources among groups of entities.

A more comprehensive approach, however, is desired to fully assess a development project. The complementation of quantitative analysis by research of social, institutional, technical and other aspects to form an interdisciplinary perspective, can justify a socially useful project even if economic returns are low. Similarly, some projects that may bring significant economic returns may be not executed if they have negative social or environmental impact.

In the context of development finance, project planning and assessment require, among others, an analysis of **project's viability**, i.e. the measure of the impact of the constraints arising from the international economy and the operation of local market. Put differently, it is important to assess the ability of the project to generate social benefits after the donors' participation is over. The decision over provision of grants or any other form of financial support (subsidies, technical assistance, etc.) is closely related to financial viability and sustainability of the project. It is, therefore, crucial to develop new and advance existing methodological approaches to decision-making over project implementation.

4.4 Policy Issues

The implementation of the **Addis Ababa Action Agenda** is currently a major goal for the international community in the context of international development and finance. The centerpiece of the Addis Agenda is aligning the financing flows and policies with economic, social and environmental objectives. In a situation when the public sector is experiencing difficulties to provide sufficient funds to support the attainment of sustainable development goals, the Addis Agenda provides a guidance on concrete measures, addresses all sources of finance, and covers cooperation on a wide range of issues.

Recognizing the need to increase funding and tailoring it to the concrete development objectives, governments, international institutions and private sector actors have realized the limitation of existing approaches to international development finance. Operationalizing the Addis Agenda relies on domestic and international private business support and finance. The need to engage the private sector is being explored in the context of innovative finance, and the expansion of innovative finance instruments is expected to help better address global challenges.

Several policy issues arise when analyzing the state of affairs and potential future developments in development finance; they relate to debt and concessionality issues, public investment and asset management, sovereign bonds, official development flows and newer issues, such as innovative finance and blending.

Debt and debt sustainability issues in particular are becoming more important due to the upward trends in developing countries' indebtedness in the recent years. Potential risks of debt crises and debt spirals in this context may jeopardize a considerable amount of development projects under implementation. Debt sustainability, i.e. the ability of a country to meet its debt obligations without resorting to exceptional funding (such as debt relief), continues to be a cornerstone of development finance.

Debt servicing does not necessarily depend on the type of public involvement, i.e. even in case of concessional funding (grants), the funding from the official donors may simply be not enough to finance country's primary deficit. Excessive debt burdens may also arise when the costs of servicing the debt become very high. Consequently, various instruments are being developed and used to minimize the risks of sovereign insolvency.

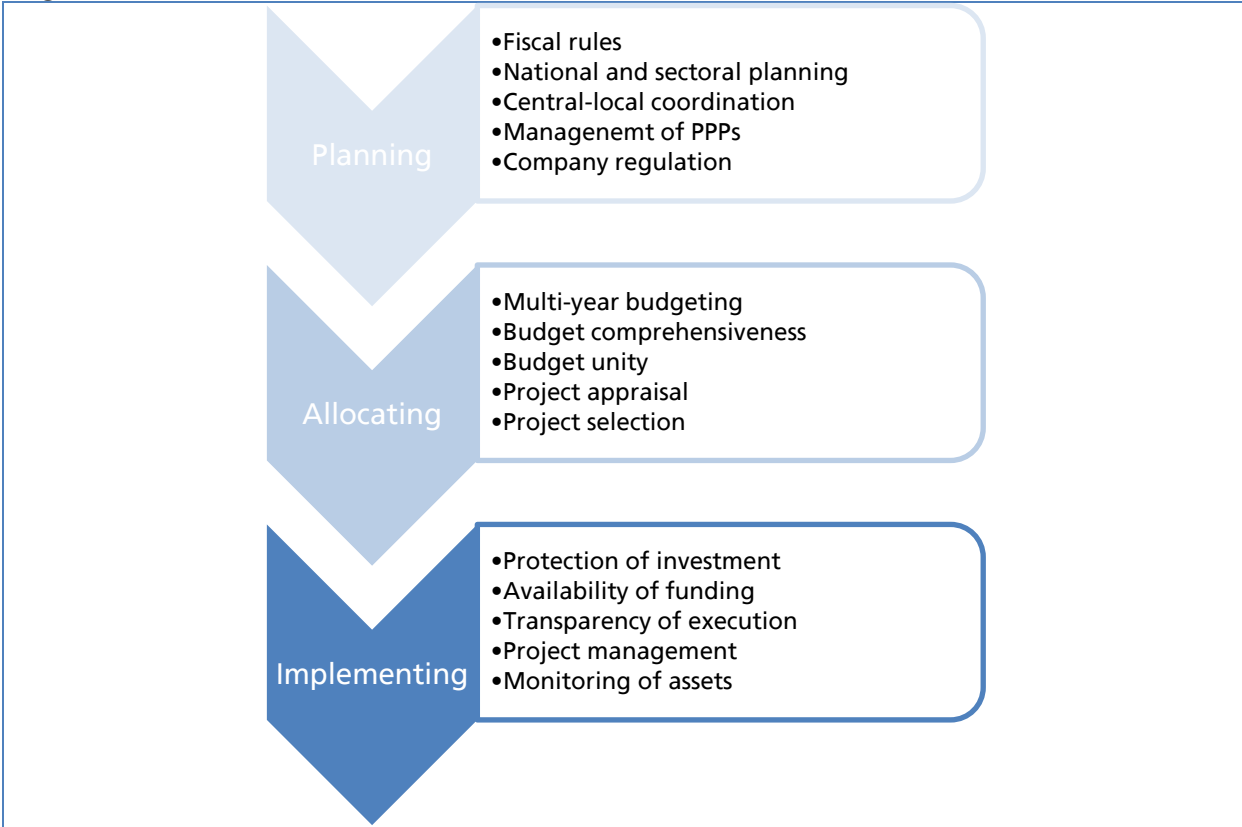
The Non-Concessional Borrowing Policy (NCBP) adopted in 2006 by the IDA applies to countries eligible for IDA grants and to the recipients of assistance under the Multilateral Debt Relief Initiative (MDRI). The latter together with the Highly-Indebted Poor Country Initiative has increased the borrowing capacity of the beneficiary countries. The purpose of the NCBP is to reach out to both creditors and borrowers to reduce the risk of overborrowing. Creditors receive information about ways to incorporate debt sustainability considerations into their lending decisions, while the work with borrowers includes capacity building and assistance in debt management.

Increasing borrowing capacity of developing countries through debt sustainability assistance and concessional financing, on the one hand, is a positive feature. On the other hand, it raises concerns about the new borrowing space, its mismanagement and accumulation of more debt. In addition, it can increase demand for grants, which, in the case of IDA, are allocated based on the countries risks of debt distress. In this context, innovative policy solutions are needed to address debt-related financing issues.

Asset management with respect to public investment is another policy issue that needs to be addressed in the context of development finance. In particular, public investment is crucial in supporting the delivery of key public services, such as social (schools, hospitals, public housing, etc.) and economic (airports, seaports, etc.) infrastructure. Efficiency of public investment defines its economic and social impact, and it depends, in turn, on asset management.

Since public investment in developing countries has started to recover after a period of decline, it is important to facilitate introduction of more efficient asset management techniques. For example, the IMF has created Public Investment Management Assessment (PIMA) tool. PIMA evaluates 15 institutions that affect public decision-making at the stages of planning, allocating and implementing a public project (see Figure 8).

Figure 8: PIMA Framework



Source: The IMF, URL: <http://www.imf.org/external/np/fad/publicinvestment/>

Issues related to developing countries’ **sovereign debt** remain a policy question which needs to be addressed alongside the discussion about development finance. In particular, poor institutions, resource management, weak or volatile currency can destabilize the economy, but even more so in the presence of high indebtedness. In case debtor countries are experiencing difficulties with repaying the debt, coordinated solutions are provided by the Paris Club. Appropriate debt treatment solutions (such as rescheduling or concessional rescheduling) are developed by the Club, and the troubled debtor countries undertake reforms to stabilize macroeconomic and financial environments.

While Paris club continues to play an important role in the existing institutional structure, the change of international finance landscape may alter future legal framework of sovereign borrowing. In particular, continuously changing composition of creditor and debtor countries, as well as the increased access to investment opportunities in the international capital markets may influence the ways developing countries mobilize capital.

The current level of financing through **Official Development Assistance** (ODA) is insufficient to meet the SDGs. With massive fiscal and monetary packages implemented in many developed countries to tackle the consequences of financial and economic crisis, the levels of ODA are still below the internationally agreed target of 0.7% of GNI.

The EU, however, made collective efforts to increase ODA in the recent years, and in 2016 has become the world's leading aid donor. Five member states (Luxemburg, Sweden, Denmark, Germany and the UK) provided 0.7% or more of ODA. 16 members continue to increase the amount of ODA, while 5 members reduce or keep the assistance at the same levels. Even through collectively the EU has not met the target, in 2015 the European Council reaffirmed its commitment to reaching the target before 2030¹⁵.

In light of often unsuccessful struggle of donor countries to increase aid, ODA and other issues of the OECD Development Assistance Committee (OECD DAC) come to the fore in international development policy making. Against this background, the international community is exploring new ways of mobilizing resources to supplement the ODA flows.

At the same time, the ODA itself requires modernization. In 2014 the DAC members introduced changes to the system by agreeing that only grants and the grant portion of concessional loans will be considered as ODA. This helps to provide more realistic picture to compare the contribution of loans and grants to the development aid, and stimulated the provisions of grants and highly concessional loans. Currently the DAC statistics includes both new system and previous cash-flow based system; and the new system will become the standard for reporting from 2018.

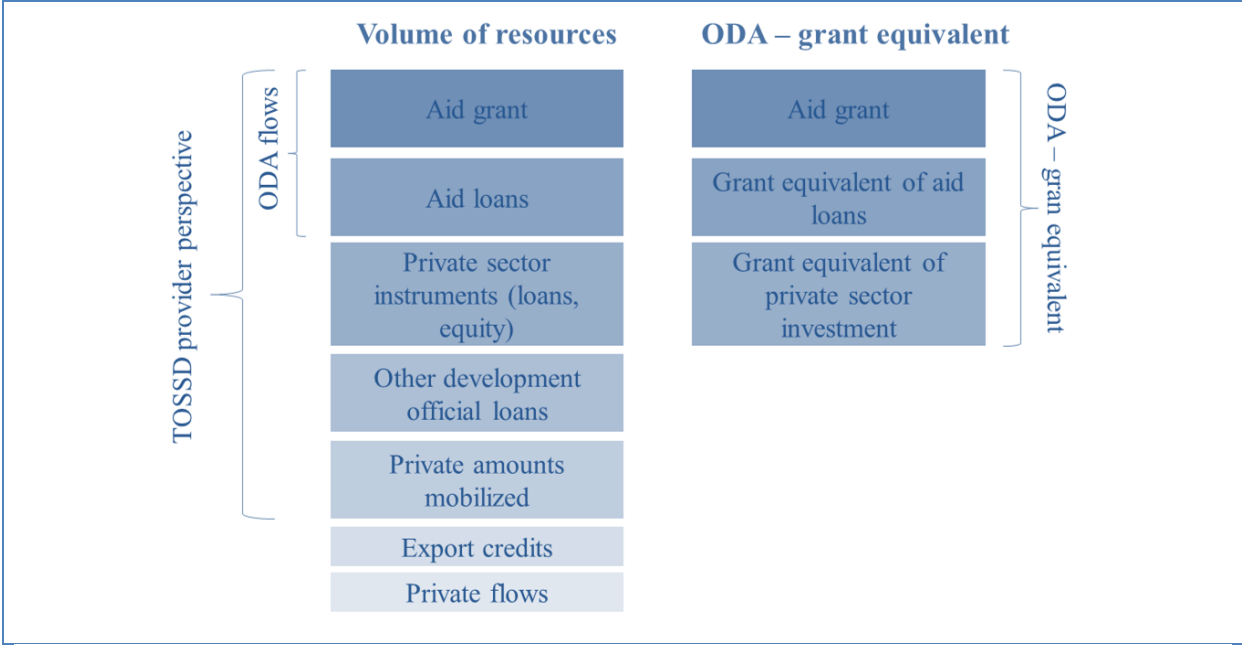
In order to compliment the ODA, to improve transparency, monitoring and assessment of development finance impact, the DAC has also introduced a new measure – **Total Official Support for Sustainable Development** (TOSSD). The working definition of TOSSD provided by the DAC is as follows:

“Total Official Support for Sustainable Development includes all officially supported resource flows to promote sustainable development at developing country, regional and global levels with the majority of benefits destined for developing countries, including those resources that support development enablers or address global challenges.”

It is clear from the definition that TOSSD is broader in scope than ODA; it includes all international public finance, such as both concessional and non-concessional public finance, as well as private finance mobilized through official interventions (see Figure 9). Therefore, in the light of changing international landscape for defining development finance, more research is needed on the policy side to assess these changes and adapt international regulation.

¹⁵ European Commission – Press Release, 2017, “EU Official Development Assistance Reached Highest Level Ever,” URL: http://europa.eu/rapid/press-release_IP-17-916_en.htm

Figure 9: The difference between ODA and TOSSD



Source: OECD Presentation, “Total Official Support for Sustainable Development,” URL: <https://www.oecd.org/dac/financing-sustainable-development/IATF%20Presentation%20TOSSD%20Compendium.pdf>

As discussed throughout this paper, the main rationale behind exploring and implementing new, innovative forms of development financing is that more resources are clearly needed to bridge the funding gap to achieve the SDGs. Public resources alone are not enough to perform this task, and private funds are seen as a tool to increasing the scope and the impact of development finance. The mix of public and private funds – **blended finance** – can allow both sectors to use their expertise in a complimentary way, increase capital leverage, and at the same time deliver risk-adjusted resources. The pros and cons of using different types of innovative finance and blending were discussed in chapters 3 and 4.1 of this paper, but obviously require deeper and more comprehensive analysis from the policy perspective.

4.5 Legal, institutional and procedural issues

Regulatory, legal and institutional environments play a major role in smoothing the operation of financial sector and economic activities aimed at achieving sustainable development. In the context of development finance, financial sector in particular ensures efficient management and integration of capital flows. The operations depend on the clarity and certainty of legal rights, predictability and speed of legal enforcement. Facilitating monitoring, enforcement and investor protection rules relies on a well-functioning system that combines up-to-date regulations, clear guideline and effective execution mechanisms.

In development finance, **legal and institutional environment** is highly complex, partly due to a large number of participants with different incentives; partly due to the nature of legal framework of the recipients. These major factors are amplified in the context of innovative financing, since the application of innovative tools has in many cases not been well explored, and some tools are still being developed. Therefore, it is particularly important to analyze existing environment related to systematic issues.

Methodologically, it has been shown in research devoted to analyzing legal and institutional environments of financial innovation (not innovative finance) that case-by-case approach should be used. Clearly, this complicates the analysis, however, given very distinct purposes of each innovative instrument, it is a necessary requirement.

Thus, provided the overview of financial products that are used in development in chapter 4.1, each of the instruments has to be analyzed separately to determine **legal and institutional bottlenecks** for investments. For instance, while for the investment in the form of equity and quasi-equity property rights and investor protection are of major importance, for risk-related financial instruments monitoring and enforcement should be addressed in the first place.

Preliminary analysis shows that for clearer identification of regulatory and institutional frameworks, with further goal to improve them, the approach should encompass multidimensionality, which in practice can be implemented through matrix-based methods. In other words, within the analysis of each instrument, a number of other issues should be addressed. The latter, for example, can include the following components relating to legal and procedural issues (if applicable to a particular instrument):

- The form of public participation;
- Nature of procurement processes, including applicable laws and regulations;
- Tariff setting and funding constraints;
- Lender issues and step-in rights;
- Environmental and social regulations;
- Foreign currency regulations, foreign exchange control restrictions;
- Labor market regulations and employment issues;
- Dispute settlement systems;
- Sovereign immunity;
- Sector regulations;
- Contract law;
- Insolvency-related laws;
- Insurance;
- Taxation;
- Standards and public liability;
- Health and safety regulations.

Similarly, for each finance product and structure, including guarantees, insurances, other risk sharing mechanisms, as well as funded grants, financial instruments and budgetary guarantees within blended finance schemes, there is a need to analyze **legal documentation and templates** being currently in use in order to improve the existing practices, as well as develop new solutions and approaches.

Analyzing the systemic issues surrounding innovative finance clearly requires raising the questions surrounding **results monitoring and impact assessment**. The former refers to ongoing developments regarding a project or a financing scheme at all stages, while the latter is used specifically to comparing the outcome of the program, policy or a project against an explicit counterfactual (usually the absence of intervention). Despite their importance, impact assessments are a relatively rare activity, largely due to its complexity and resource-intensity. Development finance institutions, for example, are being often criticized for lack of clear evidence of causal influence of development finance on poverty reduction and income inequality.

A significant amount of tools is available to conduct research and policy evaluation at the moment. However, in most instances it is hard to provide rigorous quantitative research due to lack of data.

In this regard, the experimental approach (for example, randomized control trials) help to overcome data shortage, but are usually extremely resource-consuming. Non-experimental impact assessment approaches (econometric methods, such as difference-in-difference, instrumental variables, regression discontinuity design, propensity score matching) are hard to be persuasive from the point of view of econometric inference.

Therefore, one of the key issues currently is that standards and methods of project monitoring and assessment may differ considerably not only depending on the type of the activity, but on the type of the actors involved. For example, there still exist considerable differences between assessments of various DFIs, resulting from the differences in criteria for measuring performance. In the recent years there was a turn towards harmonization of the standards, however, given the broadening application of innovative finance, the challenge still persists. In this context, one of the focuses of research should be the development of effective indicators for results monitoring and assessment.

5 IMPLEMENTATION FRAMEWORK

5.1 Overall conceptual Framework

In order to follow up its commitments in respect to the financing of SD, the EU needs to provide appropriate expertise. For such expertise to be used optimally in a particular country, it is vital that the following broad areas be considered:

- A. The starting point is the overall state of the economy, and the scale (both in terms of time and cost) of unmet SD needs. This overview should also take in the role of the institutions which finance SD and the instruments they use.
- B. Following that, market failures which prevent finance being allocated to particular SD projects/sectors should be identified and analysed. Other potential obstacles such as official debt sustainability should also be considered here.
- C. Appropriate remedies should then be proposed. For example, a failure arising from a monopoly will require a different kind of intervention than one due to an information failure. In many cases changes in the policy/legal/regulatory environment – both domestic and international – will be called for, so as to enable increased funding of SD projects via IFIs. Debt sustainability challenges may also call IFIs, for example blended financing for certain infrastructure projects and/or guarantees for providers of private finance. Timing considerations in terms of when funds are received by the recipient country may favour one form of finance, e.g. international bond issuance over others which take longer to ‘deliver’. The need to transfer risk between different finance providers in order to leverage up overall inflows points to a potential role for derivatives and guarantees. In all cases analysis of what is required, e.g. in types of new instruments which could ramp up financing of SD, will require a weighing of the benefits of such instruments against potential risks, followed by a recommendation for action.

Reflecting all the above work, steps can then be taken to ensure increased funding of SD and monitor results thereafter. It is important to consider how the expertise requested in the current tender proposal – Lot 6 - relates to stages A to C, and indeed to the seven chapters of agreements/recommendations in the Addis Agenda.

The expertise required in the ‘List of sectors, LOT 6: Innovative financing for Development’ is such as to enable steps A to C to be undertaken. This expertise may be used in more than one of these stages. Thus, provision is made in part 1 for experts on Finance Products and Structures (including equity products, bonds, securitisation etc), who could contribute to all three stages. Part 2 on Financiers/Risk Takers overlaps mainly with stage A, while part 3 on Markets and financing

needs/gaps encompasses the economic know-how to consider issues relating to possible market failures, funding additionality, and grants versus other funding channels; it thus contributes to all three stages. The Policy Issues section– part 4 – deals with the official funding channels, for example ODA, and thus potentially contributes to work in each stage. It also operationalises the Addis Agenda. In particular, it deals with the issues covered in three of the Agenda’s ‘chapters’, namely those on *Domestic public resources, Domestic and international business and finance, and Debt sustainability*. Finally, part 5 on Legal, institutional and procedural issues straddles all three stages. Moreover, its final heading, on effective indicators, results monitoring and impact assessment is crucial in ensuring that the success of the Addis Agenda being pursued is measured accurately.

In short, the expertise requested is broadly appropriate to assess the rationale for intervention, identify appropriate financing products/mechanisms, recommend steps to provide an ‘enabling environment’ for their application by the right kind of institutions/market participants, and thence ensure the financing of SD in a transparent manner. However, there is one important omission from Lot 6 – Digital Finance – which we consider needs to be addressed.

5.2 Key general considerations for Lot 6 EU experts

Experts employed under Lot 6 face a complex challenge in ensuring that SD attracts the right amount and type of financing. In doing so it is essential that they have a keen awareness of three overarching points in particular. First, it must be recognised that the situation in different countries can vary enormously, precluding the adoption of ‘one size fits all’ remedies. For example, ODA may be the only option in a conflict country, but one of many in a country at peace. Moreover, the capacity of a country to develop feasible projects, absorb external expertise and then implement the changes that are proposed, will differ from one country to another. The term capacity is used here to denote the ability of recipient country officials/businesses to fully comprehend new financing instruments and be able to address any risks on an ongoing basis, both of which can be enhanced by specific work carried out under the framework contract. Safeguarding the recipient is especially important where new complex instruments and practices such as Public Private Partnerships are introduced to developing countries. A practical understanding of available safeguards - for example regulatory sanctions for proscribed behaviour, contractual safeguards (in relation to fair terms and conditions etc), effective ways of ensuring legal and transparent process, demonstrable public support for the project in question, and fair taxation – is vital to ensure that funds are used to fund SD.

Second, it is vital to consider the overall picture rather than one segment in isolation. This means in practice having an accurate understanding of who the main players are – such as international institutions, philanthropists, banks, insurers and so on – and how they operate including the financial instruments that they use; in addition, the connections between these players and instruments should be considered. Objective data on the size of existing financing flows is essential for this.

Third, it is important that experts focus on the economic, social and environmental dimensions of the SD that is funded by the innovations they promote, together with overall development effectiveness. This requires a practical understanding of the processes in terms of financial reporting etc that ensure such concerns are fully taken into account. Transparency and with it, accountability are vital ingredients here especially when there is private financing.

These considerations underline the need for technical experts who have experience in developing countries and are fully au fait with practical ways of ensuring that the new 2030 focus on the economic, social and environmental dimensions of SD are properly taken into account.

6 CONCLUSION

First, it is important for the EU to anchor its actions in developing and implementing innovative financing instruments for development in the latest EU and international policy framework. In this respect, the Millennium Development Goals and the 2030 Agenda for Sustainable Development, the Addis Ababa Action Agenda on financing sustainable development and developing sustainable finance, the European Council conclusions on a stronger role of the private sector in development cooperation, the European Consensus on Development, and the European External Investment Plan (EEIP) constitute a very strong justification for the relevance of innovative financing for development. The most concrete agreement on innovative financing is the Addis Agenda, whose policy recommendations in essence constitute operational commitments aimed at governments, international organisations, the business sector, civil society and philanthropists.

However, it should also be recognized that innovative financing for development is not a new concept. In developing and implementing innovative financing instruments for development, it will therefore be out most importance to draw the lessons of EU experience (especially EU blending mechanisms, which take the form of geographical and sector regional blending facilities), as well as instruments used by other donors, in particular the type of financial instruments used by selected DFIs (IFC, EIB, ADB, FMO, DEG, Proparco, GCF), and initiatives such as those of the World Bank, UNTAID, The Global Fund to fight AIDS, Tuberculosis and Malaria, the GAVI Alliance, the Global Health Investment Fund, etc.

Finally, innovative financing instruments cannot be considered as “one size fits all” products and it will be important for the EU to develop a differentiated approach to problem solving and identify practical ways of ensuring that the new 2030 focus on the economic, social and environmental dimensions of sustainable development are properly taken into account.

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