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An Overview of Innovative Financial Instruments Used to Raise Funds for International Development

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Since the last global economic crisis - and possibly before - the discussion surrounding "innovative financial instruments" has once again been flourishing, and the range of proposals being debated continues to grow. The following analysis offers an overview, and explains the methods of operation as well as the advantages and disadvantages of the main proposals under discussion.
Analysis shows that innovative, high-volume financing instruments, suitable for use in a broad range of applications, are available both for developed nations and for poorer countries, with the poorer countries relying rather more on the provision of additional public funding (e.g. by means of a foreign currency transaction), whereas developed countries can mobilise private capital to a greater extent (e.g. from GDP-indexed bonds).

Despite the progress made in development, as evidenced by the MDGs, many partner countries still face enormous challenges to their development. Countering these challenges requires not only suitable policies and strategies, but also the substantial financial resources needed for their implementation. The main sources of finance for this purpose are local taxes, levies and fees and also, in the case of developed countries, borrowing from the international capital market. The international donor community also contributes to this financing through development aid. The target is that, by 2015, every donor country should be spending 0.7% of its Gross Domestic Product on development cooperation (DC - otherwise known as Official Development Assistance, or ODA).

Raising additional international funding v. using funding more efficiently and making greater use of local sources

There is widespread controversy not just over the level of funding needed to finance the process of development in emerging and developing countries, but also with regard to which sources should primarily cover that funding. Some insist on maintaining the 0.7% target (which most donors are still a long way from reaching), whereas others point out that the potential available from local sources (e.g. taxation, restrictions on capital flight) should be fully exploited first, and that those funds already in place should be deployed more efficiently (e.g. through development-oriented policies in partner countries and by tackling corruption) before there is any discussion of further increases in external aid. Others doubt whether partner countries have sufficient capacity to absorb additional funding, and some even claim that the "sweet poison" of development aid undermines local development efforts and creates political or economic dependency, so that reducing international aid would be of greater developmental benefit than increasing it.

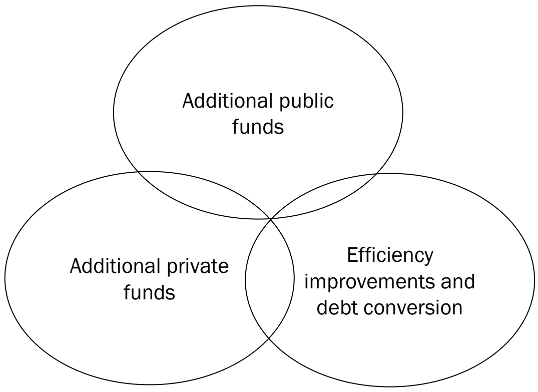
However, most are now convinced that the solution is to be found through a combination of the following: implementing policies which are more strongly oriented toward development, increasing local revenues, strengthening the focus on results, increasing efficiency and mobilising additional international funding. That which follows is primarily concerned with the raising additional international funds (and also, in part, with freeing up funds through increased efficiency); this does not mean, however, that the other areas of activity are any less important.

What exactly are "innovative financial instruments"?

It is still widely expected that the industrialised nations will increase their contributions to the financing of development processes in partner countries. However, the budgets of many industrialised countries are under extreme pressure as a result of both their own structural problems and the extensive fiscal programmes that have been introduced to cushion the effects of the global crisis, and the capacity of these nations to borrow more on the international capital market is somewhat limited.

Given this situation, "innovative finance in-

Figure 1: the relationship between innovative financial instruments



Source: author's own representation

struments" are receiving particular attention. This concept covers a number of very different proposals, which can be roughly organised into three groups:

i. Proposals whose primary aim is to provide additional public funding for international DC.

ii. Proposals whose primary aim is to mobilise additional private funding to finance development processes.

iii. Proposals whose primary aim, through increased efficiency or debt conversion, is to free up funds which can be used to finance additional measures.

Figure 1 shows that it is quite possible to have overlaps between the various groups, and that not every instrument can be allocated to one specific group.

The following provides a brief explanation of the most important instruments and the innovative mechanisms they use, and investigates their advantages and disadvantages.

Group 1: Proposals to mobilise additional public funding

New taxes and levies on specific activities, generally of a global nature (e.g. currency transactions, airline tickets, CO_2 emissions).

In order to mobilise additional funding for public development cooperation in spite of the budgetary deficits which exist in many industrialised nations, some proposals aim to improve budget revenues in donor countries by introducing new taxes (or raising the level of existing taxes) and then use the additional income primarily to expand development aid. From a tax system perspective, in many countries the allocation of general tax revenues for this purpose is not without its problems; so, in order to provide this concept with the best possible political foundation and facilitate its implementation, discussion is mainly focused on those tax issues which have global relevance (e.g. a currency transaction tax, taxation on CO_2 emissions, or levies on airline tickets).

On one hand, the obvious advantages of this proposal are its compulsory nature, which offers the potential for very high revenues, as well as its suitability for implementation across a broad range of regions and sectors. On the other hand, it is particularly with global transactions such as these that, in certain circumstances, unwelcome attempts at tax evasion can easily arise (e.g. the migration of taxable transactions to a non-participating country). In order to avoid such efforts at circumvention, the relevant regulations must be introduced simultaneously (as far as that is possible) in all those countries which are important in this context; however, from a political perspective this would be very difficult to implement. Another (relative) disadvantage is that the allocation of tax revenues can easily be changed on the basis of political expediency. There is little reason to believe that additional tax revenues will be used on a permanent basis for any other priorities than those for which general tax receipts are deployed.

Government sale/ auction of rights of use (e.g. environmental allowances, UMTS licences)

Every country owns certain rights of use which can be exploited economically and whose proceeds can be utilised for development cooperation. Selling emission allowances to businesses which are subject to the European emissions trading scheme and the auctioning of UMTS (3G) licences are two instances of such revenue sources. By way of example, the auctioning of emission allowances over the last three years has generated a flow of more than half a billion Euros into international climate-related projects from just Germany alone. Over the longer term substantially more funds could be mobilised for international development finance, especially by raising the volumes being auctioned.

One drawback with this instrument is that revenues are strongly dependent on the prices that can be achieved, and are therefore subject to the prevailing market conditions. This is presently becoming clear in the case of emissions allowances: there has recently been a drastic fall in prices, and the present price per tonne of CO_2 falls well short of expectations.

Allocating IMF special drawing rights specifically to developing countries

Special drawing rights (SDRs) are issued by resolution of the member countries of the IMF (International Monetary Fund), and SDRs are normally distributed among member countries according to the individual country's quota. In principle, SDRs are claims to currency on IMF member countries. Since – in contrast to, say, US Dollars or Euros - they are only used in trading between central banks and cannot be used as real currency for trading in goods, they have been little used to date as a reserve currency.

Various proposals for increasing global development finance are based on this SDR mechanism. For example, there could be a resolution to issue new SDRs (either in accordance with established quotas, or giving a disproportionately high allocation - or even an exclusive allocation - to developing countries), or through the transfer of existing SDRs to developing countries. Having obtained these SDRs, the developing countries could then exchange them as needed into convertible currency at the central banks of member countries, and use them to finance their development processes. In effect this conforms to something like a globally raised tax, whose proceeds are made freely available to developing countries.

The advantage of this solution is that it is a relatively simple mechanism for transferring worldwide funds to developing countries. The obvious disadvantage is that SDRs cannot be created in the volume desired without unleashing global pressure on inflation, and those member countries which exchange SDRs against convertible currency have to generate a value equivalent to those SDRs. Hence it is difficult for these proposals to gain a majority in the IMF.

Group 2: Proposals to mobilise additional private funding

Public-private partnerships (PPPs)

The term "public-private partnerships" describes widely differing models of cooperation between the public and private sectors. In those models which are of relevance here, the private partner generally takes over - either partially or completely - the prefinancing, planning, construction and sometimes even the operation of public infrastructure (e.g. power stations, roads, railways, buildings, forests) and receives in return a predetermined (sometimes performance-dependent) payment from the state. Alongside the obvious function of mobilising funds, other advantages can also be found: private companies manage these services more efficiently than state-run operations, and infrastructure created under PPPs can be completed and put to use by the target group sooner than under a purely public model. However, the high expectations that have long been placed on PPP models have proved to be somewhat unrealistic. Constellations of contracts are required which are often very complex and present major challenges to the capacity of state structures. In some cases, gains in efficiency are more than offset by the effort required to monitor the private partner's contractual performance.

Viewed overall, the potential for using PPP models in many developing countries is still relatively limited; but it is growing, and it can be expanded.

Government guarantees/ assumption of risk (e.g. IFFIm, AMC, GAVI)

Through these financial instruments the state shares in the risks and costs of developmentally worthwhile economic activities, thereby fostering a willingness among private institutions to bring funding to these initiatives.

One such example is the International Finance Facility for Immunisation (IFFIm). IFFIm borrows commercial funds on the international capital market and uses them to finance extensive vaccination programmes and measures to strengthen the health sector in developing countries. The best-known example of this is the GAVI alliance ("Global Alliance for Vaccines and Immunisation"). These funds are repaid out of future endowments from donor country development aid budgets. At present the United Kingdom, France, Italy, Spain, the Netherlands, Norway, South Africa, Australia and Sweden are involved in this model. IFFIm's creditworthiness is assured by appropriate government guarantees (undertakings from the donor countries to provide future budget funds).

Finally, IFFIm arranges commercial prefinancing to enable budget funds to be put to use. Bringing the deployment of this funding for vaccination programmes forward not only avoids future suffering and the future costs of disease (by saving the cost of treatment), it also enables cost benefits to be realised through pooling the procurement of large volumes of vaccine. As a result, the measure is either partially or wholly self-financing. To date, Germany has not participated in models of this kind either. This is partially because assigning future budget funds could adversely affect the budgetary powers of the German parliament.

"Advanced Market Commitments" (AMCs) offer another example of this kind of innovative financial instrument. Here an industrialised country will provide a guarantee, for example, to pharmaceutical companies to take specific volumes of vaccine (or medication to treat diseases typically associated with poverty, such as pneumonia or malaria) in the future at specific prices. This creates an incentive for the manufacture - and even more so, for the initial development - of such products. A further beneficial effect with this proposal is that pooling international demand for vaccines enables very low price levels to be achieved.

To date, the use of these instruments has been confined to a very few applications in the health domain, where conditions are relatively favourable. Potentially they could also be used in a few other cases (e.g. seeds and plant protection products), but on the whole their applicability appears to be limited to a few special situations.

Blending: concessionary loans combining public and private funding

As a general rule, funds from donor governments' development aid budgets are provided as non-repayable grants. These highly favourable terms are appropriate for many projects; however, other projects (especially those which generate their own income, or those which are implemented by partners with suitable economic capacity) could still achieve the purposes for which funding is being provided with significantly lower grant contributions. The funds thus saved could be used to support other projects - including further projects of the same type.

The core concept of blending is to combine low-cost budget funds with funds from the international capital market in such a way as to avoid both project underfunding and project overfunding.

The most common form of blending is interest rate reduction. Here, for example, a development bank takes a loan on the capital market at market rates, and uses grants from budget funds to reduce the interest burden across the entire term of the loan. Generally - dependent on the level of interest rate support required - a multiple (often four to ten times) of the budget funds available can be raised in this manner.

Blending has been used on an occasional basis in German development cooperation for a long time now, and many other donors see that it has major potential for raising efficiency and effectiveness in their own use of funds. The European Commission is also presently considering significantly increasing its future use of this instrument.

Loans/ bonds with performance-dependent repayment terms (e.g. counter-cyclical loans / GDP-indexed bonds)

For many developing countries, access to international capital markets is not only limited - due to the state of their economies, which in many cases are still weak and crisis-prone - but also relatively expensive, due to the increased risks involved. Because of this, some proposals seek to make bond and loan repayment terms dependent upon the debtor country's economic performance, so that more funds are repaid in good years and less in bad. This approach can help to avoid debt spirals and thereby reduce the risk of credit default. Under the "counter-cyclical loans" model developed by AfD, the French development bank, certain pre-defined trigger events (e.g. a fall of x% in crop yields or export revenues) will determine whether the debt servicing term is automatically extended. In the case of GDP-indexed bonds, debt servicing is directly dependent on the rate of growth in Gross Domestic Product.

These instruments can only be used in those countries which, given normal economic development, are basically creditworthy. The potential for mobilising funds here is very high; however, to date this instrument has only been used in a few countries and, due to the difficulties of calculating repayment streams, it has met with only limited interest among financial investors. It is possible that international development banks could make greater use of this instrument and thereby increase its market popularity.

Securities / structured funds

Put simply, in the case of securities, loan repayments are secured against the assignment of future cash flows. As an example, government bonds can be secured against income assigned from oil production; oil revenues are immediately transferred into a trust account, from which the trustees service the loan repayments first, with only the remaining balance being forwarded to the debtor.

Structured funds operate in a similar fashion to the securities described above; but in addition to providing security against future revenues, these structure the risk as well. The overall risk is divided into tranches, each with different degrees of risk, and these are passed on to investors with varying risk appetites. This means that, ultimately, private capital is mobilised to finance development processes.

In development cooperation, this instrument is often used when refinancing financial institutions (including microfinance institutions) in partner countries. Hence the (micro) loans issued by local financial institutions serve to secure the international loan granted to the finance institution itself. In simple terms, this international loan is divided into three tranches: the "first loss" tranche, the "mezzanine" tranche and the "senior" tranche.

All defaulting amounts from the (micro) loans are borne in the first instance by the first loss tranche; it is not until this tranche has been fully consumed (i.e. the first loss investors' capital has been entirely lost) that the mezzanine tranche takes the load; and the senior tranche is only called upon to cover losses once the mezzanine tranche has been completely exhausted. The first loss tranche is designed at a certain size (say 5% of the total loan) so that it covers all the loan defaults which are to be expected (on the basis of experience) and still retains a good safety margin. However, this tranche is virtually impossible to sell on the capital market, and it therefore stays with the (micro) lending institution or the development aid donor. Because of its low risk level, the senior tranche (which is generally around 80% of the total amount) can usually be placed on the capital market at very favourable rates, and the mezzanine tranche (perhaps 15% of the volume) can, in general, also be sold on the capital market (with an acceptable level of discount), or it may be taken over by financing institutions. As a result, up to 95% of total financing can be placed on the capital market and can thereby be raised from private investors.

Securities and structured funds have significant potential for mobilising funds; however, they can only be used (a) in partner countries with well developed financial markets and (b) for those products which have relatively secure future income streams.

Ethical funds/ ethical bonds/ diaspora bonds

As a general rule, ethical funds and ethical bonds are private investment funds or bonds which, as well as targeting a positive return, also consider ethical aspects in their investment decisions, and are therefore prepared to accept some reduction in the level of return achieved. As an example, funds and bonds of this sort may invest in companies which have a particular added value in developmental terms. These funds and bonds generally focus on a specific sector or region. For instance, the World Bank issues "Green Bonds" for the environmental domain and "Cool Bonds" for climate-related projects.

In order to guarantee the quality of developmentally motivated projects, greater expenditure is generally required when selecting investments; this puts further pressure on returns.

"Diaspora bonds" operate in a similar fashion. Citizens of developing and emerging countries who are living abroad often have a particular interest in supporting the development of their homeland. As a result, they are often prepared to forego their "returns". Unlike purely commercial investors, if economic difficulties arise, they do not immediately withdraw their funds. Diaspora bonds are predominantly suited to countries which have a large number of nationals living abroad who have strong ties to their homeland (e.g. India, China and Israel).

Both ethical funds/ ethical bonds and diaspora bonds can mobilise additional private funding to finance development processes; however, due to the limited willingness of investors to forego returns, their potential is at present still relatively limited (although their future prospects look positive).

Loans issued in local currency

In development cooperation, funds are traditionally issued in internationally convertible currencies. This means, however, that the debtor is burdened with the entire foreign exchange risk, which is a heavy load to bear, especially for actors in developing countries. Small and medium-sized enterprises are particularly affected by this, since they usually only have their local currency revenues available. Making it possible for these companies to repay loans in local currency reduces their risk of default and improves their access to credit.

Although the exchange rate risk now remains with the lender, the lender can spread it more easily between various countries and secure the risk via capital market instruments.

This instrument's potential for fund mobilisation is rather limited, but it can be used in a relatively broad range of applications.

The Clean Development Mechanism (CDM) and the Adaptation Fund (AF)

It is not only the initial auction of emission allowances which mobilises funds for development finance, but also the subsequent sale of emission allowances under the "Clean Development Mechanism" (CDM). Here, when a developing country builds a wind farm, for example, it can obtain allowances commensurate with the emissions saved compared to thermal power stations, and sell them to a company in an industrialised country which has reduction requirements. This means that the funds flow directly to the project in the developing country. Between 2005 and 2011, the sale of emissions allowances enabled around USD 33 billion to be mobilised for projects in developing and emerging countries. However, as with the auction revenues described above, the level of funding raised for individual projects is strongly dependent on market prices.

Furthermore, 2% of sale proceeds go into the Adaptation Fund (AF); this enables even those developing countries which have not sold any allowances to obtain funding to finance special projects for climate change adaptation.

Lotteries

Lotteries also enable private funds to be mobilised for development tasks. For example, the "Belgian Technical Cooperation", together with Belgian NGOs and UN organisations, organises a national lottery, from which 20% of sales goes into the "Belgian Fund for Food Security", which finances food security projects in developing countries affected by famine. Along with the ethical question of whether a government should promote games of chance, it should be borne in mind that, as an instrument for fund mobilisation, lotteries provide fairly low amounts and are volatile in nature.

Group 3: Proposals which free up funds for development tasks through efficiency improvements or debt conversion

Results-based Financing / Output-based Aid / Health Impact Fund (HIF)

The particular feature of this type of instrument is that payment is made not for the input required to complete a developmentally relevant initiative (e.g. building a school) but for achieving an effect (e.g. an increased number of successful school-leavers). Output-based aid and voucher systems are variations on this model.

The main advantage of this group of instruments is that they create excellent incentives for partner countries to achieve results quickly, and that they can do so entirely under their own responsibility. The drawback is that these instruments can only be considered for comparatively advanced developing and emerging countries, which not only have the necessary capacity for planning and implementation, but are also able to pre-finance the relevant initiatives until their effects are achieved, Furthermore, both the attribution and the measurement of effects have proved very difficult in practice, and hence these instruments - in their purest form - have so far hardly been used; however, despite this they do offer some potential when used in parallel with improved systems of measurement.

One particular instance of success-dependent financing is the “Health Impact Fund” (HIF). Under this proposal, which was developed by an international group of academics, pharmaceutical companies would no longer receive a fixed price for medication sold, but be rewarded instead with a set amount (out of an international fund for medicine) for achieving a particular verified effect (e.g. a decline in the incidence of tuberculosis following the introduction of a new medicine into a developing country).

This would give pharmaceutical companies an incentive to concentrate on the development of highly effective medicines and - equally important - to ensure that patients use medications as intended, instead of the firms boosting their sales turnover through continuous increases in advertising expenditure, which may ultimately only serve to raise the price patients pay for their medication. This proposal also involves cost reductions through efficiency increases.

Weather insurance and catastrophe insurance

To a certain extent, some insurances (e.g. insurance against crop failures or catastrophes in developing countries) can be counted as innovative financing instruments. An interesting feature of insurance is that the average initial risk of a claim (which must form the basis on which the premium is calculated) can be reduced by spreading the risk very widely.

Under the “Caribbean Catastrophe Risk Insurance Facility” (CCRIF), sharing the risk of the 16 member states enabled premiums to be reduced by around 40%, compared to the amount which would have had to be raised for an individual country. One disadvantage of this instrument is that it has relatively few applications, and as a result the volume of funds freed up for development finance purposes remains very limited.

Conditional debt forgiveness, debt buy-back and debt-for-development swaps

Conditional debt forgiveness relieves a developing country from repaying a loan (or a part thereof) if it satisfies certain stipulated, developmentally relevant conditions (e.g. attaining a specific level of vaccination).

Debt buy-back, which is frequently used in IDA and IBRD loans, is similarly configured. Here a third-party donor repays the creditor on behalf of the developing country, subject to certain conditions being satisfied.

In contrast, under debt-for-development swaps, the developing country agrees to deploy a sum equivalent to all or part of the value of the debt written off in return for specific developmentally relevant measures, such as nature conservation (debt-for-nature swaps) or health initiatives (debt-for-health swaps). What all these instruments have in common is that, in the strictest sense, they do not mobilise any additional external funds (i.e. no “fresh money”); rather, they reduce repayment obligations on (typically) inter-country loans and, in this respect, only free up funds indirectly, so those funds can then be used for other developmentally relevant tasks.

These instruments are primarily of interest for poor, highly indebted countries. Moreover, many of this group of countries’ public debts have already been forgiven or restructured in earlier rounds of debt re-negotiation, so the opportunity to use these instruments is now limited. Fundamentally, it should be borne in mind with all forms of debt relief initiatives that - through the expectation of further debt write-off at a later date - they can lead to an excessive increase in the willingness to take on debt.

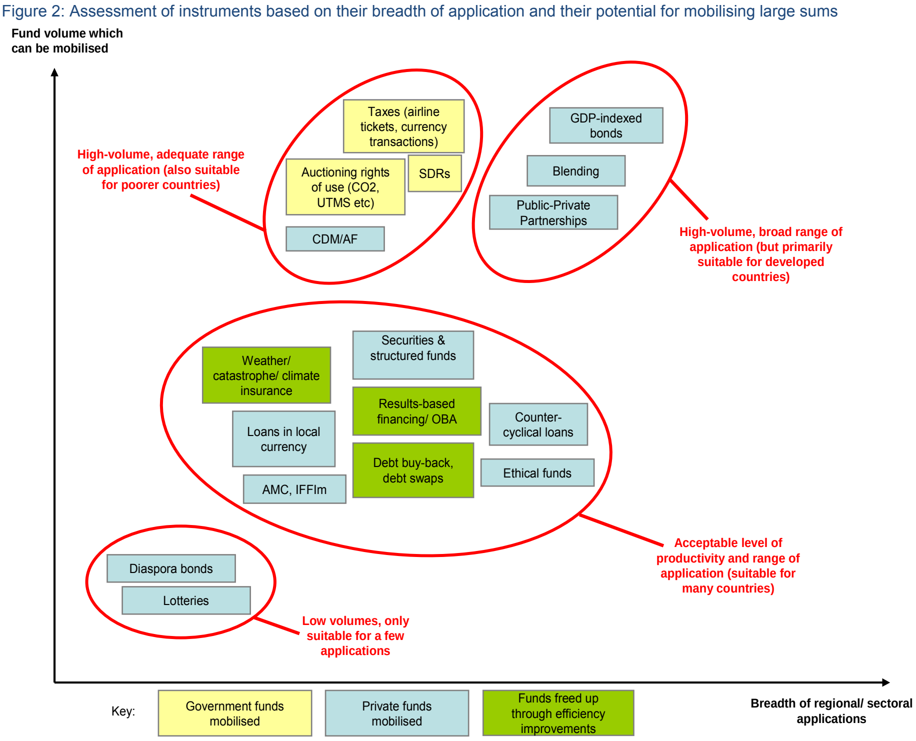
Conclusion: several instruments have widespread applicability and offer good potential for mobilising funds

A large number of proposals on innovative financing mechanisms are currently being discussed among development experts. The degree of innovation within these proposals varies considerably - some have already been used in practice for many years. These instruments differ with regards to two important criteria: firstly, the number of situations and countries in which the instrument can be utilised; and secondly, the level of funding which, given favourable operating conditions, can be mobilised by using that instrument.

As shown if figure 2, four different clusters of instruments can be identified. For developed countries, there is a group of instruments which are very effective and which can be used in a broad range of applications; all of these mechanisms are based on mobilising additional private capital. There are also high-volume instruments for poorer countries; their primary aim, however, is to mobilise more public funds. The use of instruments in both these clusters should be pursued with vigour. At the other end of the spectrum, there are instruments which will similarly mobilise private funds; however, these will either not raise high volumes of funds or they cannot be used in a broad range of applications, and hence overall they have relatively little significance. And in the centre, there is a broad palette of instruments - some designed to boost efficiency, other to mobilise private capital - which have an acceptable level of productivity, and which can also be used in a wide range of situations. These should be developed further, and put to use in suitable applications.

Viewed against the total volume of develop-

Figure 2: Assessment of instruments based on their breadth of application and their potential for mobilising large sums



Source: author’s own representation

ment finance, the proportion of innovative financial instruments is rather modest; however they have increased in importance, and they represent a significant amount of unused potential. ■

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