KfW Development Bank

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Mobilisation of private capital
What contribution can development banks make

Author: Dr Carmen Colla
Editor: Samiera Toma

The adoption of the Sustainable Development Goals (SDGs) has set new standards in development cooperation, along with the international Paris Agreement on climate change, which has produced highly ambitious climate objectives. Fulfilling these agreements cannot be financed with public funds alone, however. The United Nations estimates that an additional USD 2.5 trillion needs to be invested in development and the climate on an annual basis. Even if the target ODA ratio of 0.7 % is achieved in all donor countries, this alone is not enough to close the financing gap. By contrast, according to a UNEP study, banks are currently managing USD 140 trillion in private capital worldwide. To be added to this sum are USD 100 trillion in investments with institutional investors such as pension funds, and USD 173 trillion as investments in the capital market. Only when public donors simultaneously direct this private capital to development policy measures to a significant extent will the SDGs and climate objectives be within reach. Development banks like KfW can make a key contribution in this regard.

Co-investments from private investors in the focus of current discussions

Private capital can flow into projects that are developmentally sound or have special ecological significance in very different ways: (a) as co-investments of international private investors in development cooperation projects, (b) as remittances, (c) as direct foreign investments, (d) at local level, in particular as capital investments or in the form of private entrepreneurship.

All of these capital flows are important elements of development financing. Through various cost and/or risk-mitigating measures, development finance institutions have the option of encouraging private co-investments. They can close financing gaps through issuing (soft) loans or grants to make projects fundable. In addition, they can assume the role of anchor investors who send positive, confidence-building signals as to the feasibility and quality of projects. Thanks to these signals, private investors can be introduced to new asset classes that are unknown to them and therefore carry greater uncertainty. By using instruments such as guarantees, subordinated loans, structured funds, and not least within the framework of PPPs, development finance institutions can reduce actual risks in addition to investors' subjective risk assessments, thereby making projects attractive for return-oriented investors too. With structured funds in particular, KfW has played a pioneering role and meanwhile implemented 13 such initiatives.

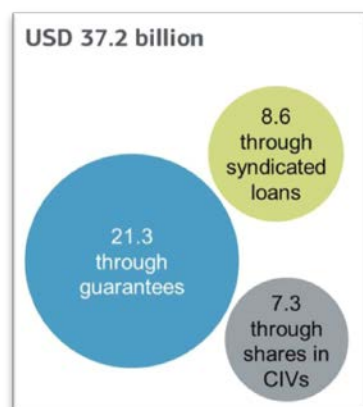
Thus approaches for capital mobilisation are varied and are already being adopted effectively. In 2015, the OECD collected figures on mobilised private capital for the first time. According to these figures, in the period from 2012 to 2014 a total of USD 37.2 billion of private capital was attracted

to projects relevant to development

››› Structured funds

Structured funds offer capital investors different asset classes (tranches) depending on their risk preference. Public funds typically provide financing for a risk buffer (first-loss tranche). In the case of a loss, the fund initially only exhausts the capital of this highest-risk tranche. The so-called mezzanine tranche, in which development banks tend to invest, bears any losses that go beyond this. The senior tranche, on the other hand, exhibits the lowest risk and is therefore also attractive for private, risk-averse investors. Only when first-loss and mezzanine tranches are exhausted do losses occur in the senior tranche.

policy by using public guarantees, syndicated loans and structured funds alone – and the trend is increasing. Development banks mobilised a good 3% (USD 1.2 billion) of this volume (source: OECD).



Mobilised amount by instrument in USD billion. Source: own presentation based on OECD (2016).

What contribution can development banks actually make to the mobilisation of private capital?

This initially relatively small share, however, does not reflect the actual significance of development banks for the mobilisation of private capital. Their contribution takes the form in particular of attracting private capital at local level, only a small proportion of which is taken into account in the OECD survey. From a sustainability perspective, it is precisely local (capital) investments and private entrepreneurship that contribute to the sustainable development of a national economy, and so their mobilisation is of crucial significance. However, it is more difficult to account for these investments when compared to international co-investments.

It needs to be stressed that improving relevant framework conditions is particularly crucial for stimulating such local investment. But in addition to creating legal and regulatory framework conditions, prerequisites for private investments and growth include the financing of infrastructure (transport, energy, education, urban development, etc.) and the construction of stable financial systems, including functioning capital markets. The creation and promotion of these prerequisites form part of the core activities of development banks like KfW. It is first and foremost the financial sector that acts as a catalyst for investments and employment in a national economy. It mobilises savings, ensures the efficient use of capital and therefore contributes to the promotion of local sustainable investments. A stable, developed financial sector assumes a key role in mobilising private capital for sustainable growth and development.

What is KfW already doing here?

With a 20 % share in the overall portfolio, KfW Development Bank and DEG are very active in the financial sector. Companies and private households, as always, suffer from chronic shortages in developing countries when it comes to needs-based finance. More than 50% of small and medium-sized enterprises (SMEs) in developing countries have no formal access to loans.

If we include small and informal companies in this, the percentage is even considerably higher (source: World Bank). One problem in developing countries in particular is that too little long-term financing is available. Banks are more likely to grant loans with short to medium terms; lending is often inefficient and venture capital is rarely offered. Accordingly, equity investments and long-term credit lines to local finance institutions that offer needs-based financing make a key contribution to widening the scope of local finance. Grants for consulting services support many of these projects, in particular when introducing or optimising financial products. For example, KfW Development Bank is supporting the Indian Small Industries Development Bank (SIDBI) with EUR 53 million, with the goal of expanding the financing of innovative start-ups and SMEs with a focus on energy and resource efficiency and environmental protection. A EUR 1 million accompanying measure is supporting the partner in managing the programme. The focus here is primarily on the identification and technical assessment of innovative projects. This support has allowed to strengthen the SIDBI in its strategic position as an environmental bank and to enhance the structuring of additional financial instruments in this area.

››› Different mandates

Generally speaking, relatively significant and direct mobilisation effects are achieved by international finance institutions (IFIs) and development finance institutions (DFIs) such as DEG. Their mandate is to promote the private sector by way of offering direct financing and to enter into co-financing arrangements with private companies. The situation is somewhat different with public development finance institutions, such as development banks, which cooperate predominantly with public institutions and whose mandate is to finance public tasks (e.g. financing public infrastructure or healthcare providers). In light of the low or non-existent microeconomic profitability of the investments, they are only able to attract private co-investors within certain limits. Impact investors, willing to forego part of their returns to help achieve ecological and social objectives, are the main potential financing partners for these institutions. These range from philanthropists to institutional investors. However, in the current interest rate environment, it is also possible to attract commercial investors ready to run higher risks in exchange for potentially higher rates of return in growth markets, developing countries and emerging economies.

Supporting underdeveloped capital markets represents another key building block in the strategies for mobilising local capital. Private finance is provided via capital markets, for growth and innovations in companies in particular. However, government bonds and debentures have so far dominated the capital markets of developing countries. Secondary markets have barely begun to develop, meaning there is a lack of liquid capital. For this reason, the development

of local capital markets is an area that is also increasingly a priority of KfW Development Bank. Risk-mitigating approaches play a key role in this regard for potential private bond investors, such as securitisation structures or assuming local currency risks. In this way, local capital markets can be built up and private investors can be introduced to new markets. The African Local Currency Bond Fund founded in 2013 is an example of one of the first KfW approaches in this area. It invests in local currency bonds issued by African banks and companies. The Fund acts as an anchor investor and – in this way – attracts private investors, pension funds and (pension) insurance funds to make further investments in these bonds.

Methods for measuring capital mobilisation through credit lines

As described, credit lines (long-term loans to finance institutions in partner countries) are a core instrument in developing financial systems and for mobilising local capital. KfW has therefore developed a method to measure credit lines' mobilisation effects that integrates into the approaches for guarantees, syndicated loans and structured funds already developed by the OECD. The mobilisation effects of credit lines go beyond pure co-investments from (international) private investors, however: generally speaking, credit lines help to create financing offers for customer groups not previously reached, and to introduce new asset classes through the supported finance institutions. Long-term refinancing through credit lines serves as start-up funding. In light of the shorter-dated sub-loans, partner institutions can use the provided funds several times. If credit lines are issued via financial intermediaries as loans to private sub-borrowers, they are redeemed from the borrower's private capital. As a result, and according to the OECD approach, the volume of public credit lines themselves, i.e. the first use of the credit lines, is considered public capital in OECD statistics. But all additional loans provided for additional financing after the first use and repayment from private funds can be considered privately mobilised.

Structure of a credit line

If KfW, as illustrated in the diagram below, issued a credit line for EUR 50 million with a term of 15 years to a bank, the bank could issue up to the triple amount of funds from the credit line, if the average sub-loan term is five years.

The initial disbursement would be included as a public contribution in the OECD statistics, whilst EUR 100 million (two times the original EUR 50 million) would be classified as mobilised private capital.

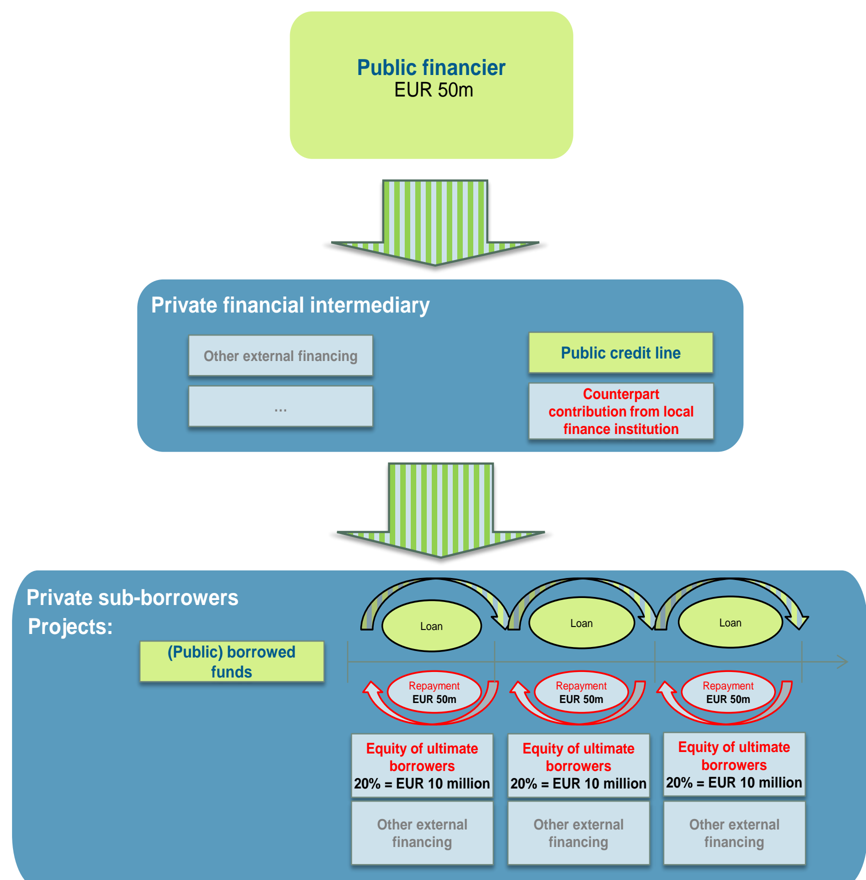
Moreover, this can result in additional mobilisation effects in the form of co-investments when on-lending the funds:

- Based on contractual regulations with the (private) intermediaries on counterpart contributions, additional private funds can be included in the sub-loan.
- Other mobilisation effects also emerge from the fact that (private) sub-borrowers generally need to make their own capital contributions, i.e. an investment is not wholly financed by third parties but partially self-financed.

With an average own capital share of at least 20 % of the volume of lending, an additional EUR 30 million of private capital would therefore be mobilised in the example above. Moreover, if private co-funding was added at the level of the local bank, the mobilisation effects would be even higher. Through the long-term financing as part of a credit line of EUR 50 million, additional private capital amounting to at least EUR 130 million can therefore be directed to important development investments.

Where is more potential?

The mobilisation of private capital at local level therefore forms part of the development banks' core business. In addition to the further development of existing instruments, the additional potential in the area of capital market development should be explored. New forms of cooperation and partnerships with private investors as co-financiers should also be examined.



Financing structure of a credit line. Source: own presentation.

The following approaches are therefore key in the further development of the instruments:

- Loans and credit lines are the main component of development banks' activities. By using both instruments for direct capital mobilisation in a more targeted way, for example in the form of subordinated loans, their mobilisation effect could be further enhanced.
- Equity investments and structured funds are also predestined to direct private investments towards development projects. By systematically including impact investors and philanthropists, whose in-vestment criteria are also geared towards positive social/ecological effects besides positive returns, the spectrum of private investors could be expanded. The same effect can be achieved by mobilising small investors – potential that must be investigated by means of more systematic analyses.
- Guarantees and insurance approaches are already a component of these instruments, yet they are found in development banks' portfolios to very different extents. As risk relief is a key factor in capital mobilisation, it should be analysed how these instruments could be used more in future to crowd in private capital.

Limits of capital mobilisation

Given the need to boost the inclusion of private capital in environmental and development policy projects, the principle of subsidiarity applies. The use of public funds should be limited to projects with developmental policy objectives where private investments are not being made or are insufficient due to low profitability, high insecurity or market entry barriers. The efficient use of limited public funds demands the inclusion of private capital wherever possible. Measuring the mobilisation effects achieved is therefore used increasingly to assess efficiency in the deployment of public funds. This statistic, however, should not be interpreted regardless of the underlying need for support. In the case of high market entry barriers, private investors can ultimately only be convinced to commit where there are high incentives. At the same time, achieving the highest possible private financing share should not become an independent goal of development cooperation. This is because the greater the proportion of private capital in relation to public capital introduced, the more pressing the question as to whether a project would have been implemented even without public funding becomes. Instead of mobilising private capital, private capital would actually be displaced with public funds (crowding out). The investments needed to attain development policy goals are too high to risk windfall profits, let alone the displacement of private players. The mobilisation of private capital should thus be an integral part of development policy activities. However, it must neither be forced at the expense of the actual objectives, nor lead to a crowding out of private players.

Conclusion

The inclusion of private capital in FC projects is becoming increasingly significant in light of the great environmental and development policy challenges. Exchange within the donor community is essential to leverage potential and identify suitable innovative approaches for the strong and efficient inclusion of private capital: a common understanding of the term "mobilisation" and comparable, transparent measurements of mobilisation effects are key foundations for this process. However, it is also important to know that the mobilisation of private capital encompasses more than co-investments at international level, which can be measured and defined relatively well. Rather, it is also about mobilising capital in the partner countries themselves.

This is exactly where KfW makes an important contribution with the development of innovative approaches to capital mobilisation. This is because, within its mandate, the main focus area of its work is the financing of sustainable framework conditions for local private investments.

››› Further information

https://www.oecd.org/env/researchcollaborative/

https://www.kfw-entwicklungsbank.de/PDF/Download-Center/Materialien/Nr.-9_Proposal-of-a-methodology-for-tracking-publicly-mobilized-private-climate-finance.pdf

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Contact

KfW Group
KfW Development Bank
Palmengartenstrasse 5-9
60325 Frankfurt am Main, Germany
Telephone +49 69 74310
Fax +49 69 7431 2944
info@kfw-entwicklungsbank.de
www.kfw.de

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