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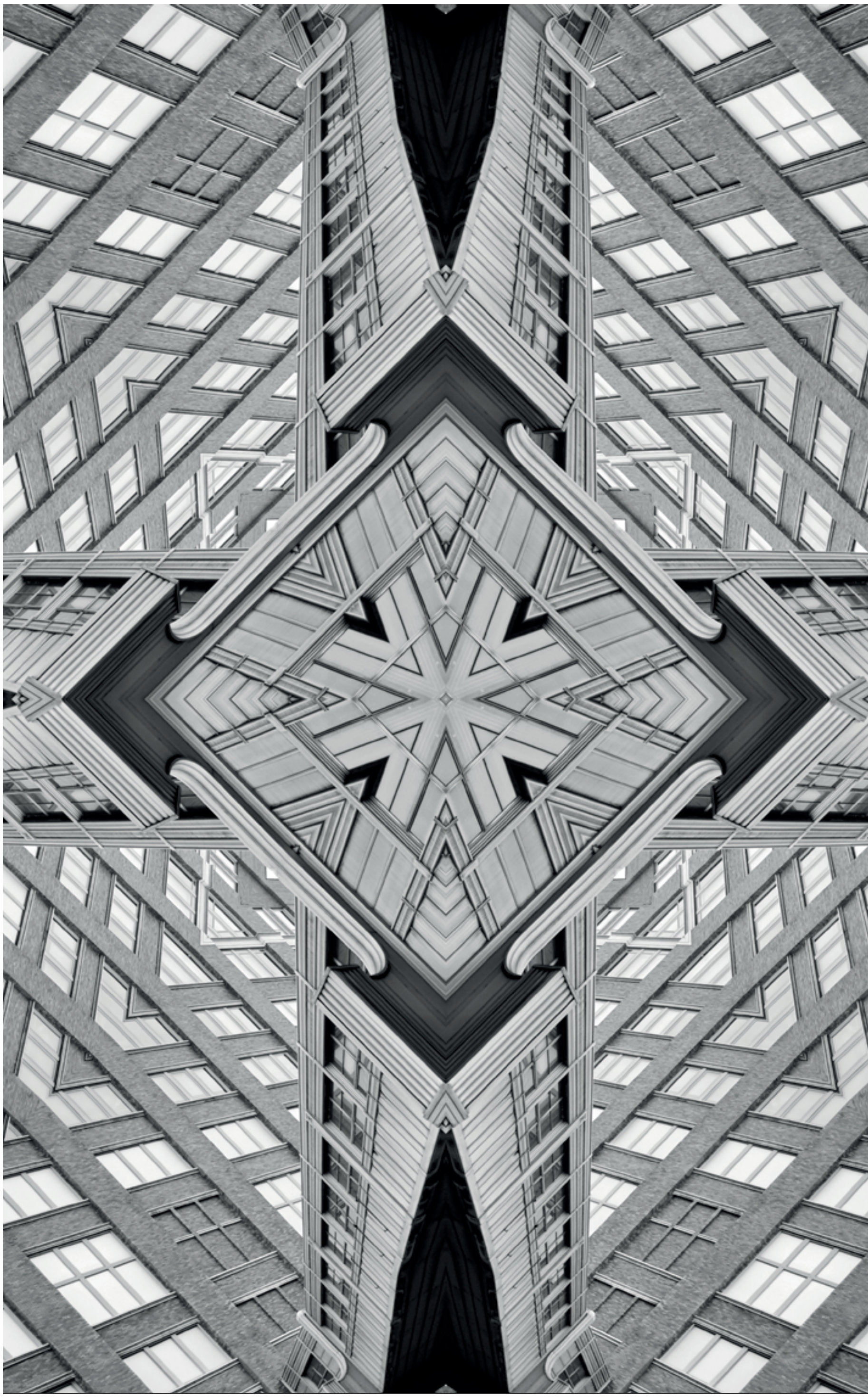

Exploring New Trends in Development Finance through Private Capital

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Abstract

This brief examines the efficacy of the inclusion of private capital in development finance, using the cases of certain countries that have met with success in utilising such a strategy. It underlines the experiences of institutions like the Japan Bank for International Cooperation (JBIC) and the United States International Development Finance Corporation (US-IDFC) that use innovative financial tools to support international financial institutions especially in the areas of ESG investments (Environmental, Social and Corporate Governance). The brief recommends the nurturing of a strategic alliance between development finance institutions (DFIs) in the Indo-Pacific region.

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Introduction

In recent years, there has been a growing trend of utilising the functions of Development Finance Institutions (DFIs) to link private investment in supporting the economic development of low-income and emerging economies. While government-to-government financing through these countries' Official Development Assistance (ODA) programmes has conventionally played a key role, governments of host countries are expanding the use of private entities for project development and implementation. The latter is done through public-private partnerships (PPPs).

In this context, countries like China, the US, and those in Europe, are strengthening their DFI functions to improve the competitiveness of their own industries and strengthen their geoeconomic influence. DFIs in these countries are enhancing the coordination of their efforts, and private sector financial institutions are making proactive use of DFIs in response to the global trend of channeling more investments on ESG aspects (Economic, Social, and Corporate Governance).[a] This brief examines global trends in the strengthening of DFIs. It focuses on the initiatives of private sector financial institutions amidst the manifold impacts of the COVID-19 pandemic, as well as the geoeconomic shifts occurring in many parts of the world. The brief will outline recommendations for the potential utilisation of Indian DFI.

> "While ODA has been key in the past, governments of host countries are now using PPPs to support economic development."

a ESG means using Environmental, Social and Governance factors to evaluate projects, companies and countries on how they promote sustainability.

DFIs in Development Finance: Growing Expectations

Traditional forms of ODA such as grants and concessional loans have played a crucial role in development financing. In more recent years, the role of financing support for the economic development of low-income and emerging economies through the mobilisation of private capital investment has been expanding. DFIs are playing a role in supporting development finance through private sector investment. A DFI's financial support is expected to serve as a bridge between a grant or concessional loan, and market-based private-sector financing, and its presence in the private and public sectors is being greatly enhanced.

DFIs promote foreign direct investment through a wide range of financing tools—such as loans, guarantees, political risk insurance, and equity participation—extended to host governments, governmental institutions, local entities, or specific projects. These harness the potential of public-private partnerships (PPP), encouraging economic development in low-income and emerging countries and sectors where various risks disincentivise private investment.[b] Therefore, private developers and operators rely on DFIs to be a source of funds, as they have the capacity to appropriate risk allocation with the host governments. For their part, host governments that suffer fiscal constraints are appreciating the use of DFIs to promote economic development by promoting private investment.

DFIs are often established as independent institutions or as part of public financial institutions with the backing of national governments, as well as international organisations such as the World Bank Group and the Asian Development Bank, and other regional financial institutions. Large economies in Europe, as well as China and the US, are strengthening efforts to enhance the international competitiveness of their own industries and strengthen their geopolitical and economic influence globally, by evolving their own DFIs strategically. This becomes important in response to the expanding role of private investment, geopolitical instability such as the US-China strategic rivalry, and the ongoing COVID-19 pandemic. In the case of Japan, for example, policy-based institutions such as the Japan Bank for International Cooperation (JBIC)[1] have also been providing financial support to developing countries with a focus on supporting Japanese companies to invest overseas.

b These challenges include political risk, foreign exchange convertibility risk, and insufficient legal and regulatory frameworks.

Europe

DFI is a concept that started in Europe. The Commonwealth Development Corporation (CDC),[2] the first DFI in the United Kingdom (UK), was established in 1948 after the Second World War as the Colonial Development Corporation; since then, countries across Europe have established their own DFIs to financially support private investments in developing countries. In 1992, the CDC initiated the establishment of the European Development Finance Institutions (EDFI)[3] as a coordinated platform for DFIs in Europe, and EDFI has since grown to include 15 European DFIs. EDFI also collaborates with international organisations to share know-how and formulate cooperative projects among European DFIs.

In May 2019, the EDFI made a decision to focus on Europe's leading global agenda, such as the Sustainable Development Goals (SDGs) and the Paris Climate Agreement. To conduct asset management operations, including management of funds using EU funds, the EDFI established EDFI Management Company (EDFIMC)[4] as a subsidiary in 2016. The EDFIMC's priority measures include climate change as well as electrification in developing countries, and is strengthening efforts to mobilise private capital for high-risk projects in low- and middle-income countries. EDFI is also working with international organisations such as the International Finance Corporation (IFC) and the European Investment Bank (EIB) to develop guidelines to promote the development impacts of blended finance.[c,5] EDFIs are shifting their financial tools from traditional lending to subordinated financing such as equity investment and mezzanine financing,[d] and they are moving toward effective mobilisation of private-sector funds by utilising the fund management function of EDFIMC.

DFI is a concept that started in Europe after the Second World War.

c 'Blended finance' is the targeted use of development finance in high-impact projects in which actual or perceived risks are too high for commercial finance alone.

d 'Equity finance' and 'Mezzanine finance' are subordinated to senior loans where commercial financing is active.

China

China's biggest DFIs include the China Development Bank (CDB), the Export-Import Bank of China, and the Silk Road Fund. Beijing is actively using DFIs to expand its flagship Belt and Road Initiative (BRI). For example, the CDB, which has set itself the vision of becoming one of the world's leading DFIs,[6] has provided more than US$ 30 billion in loans for more than 100 BRI projects in Eurasia, Africa, and Latin America. These loans are supporting Chinese companies participating in many of the targeted infrastructure and energy-related projects; they also serve as an important tool in the Chinese government's geoeconomic approach.

China's move on its DFIs is welcomed by host countries with huge infrastructure needs. At the same time, however, these DFIs have produced projects that lacked key elements of "bankability"—such as debt sustainability, legal compliance, and governance—and provoked criticisms from the international community. Among the more prominent examples is the Hambantota port project, which resulted in a "debt trap" for Sri Lanka.[7] China has taken the criticisms into account, and announced that the issue of debt sustainability will be considered for future BRI projects, and that it will cooperate with international organisations and DFIs from other countries.[8]

Amidst the severe economic fallout of the COVID-19 pandemic, issues such as how to provide financial support to ensure debt sustainability in the future have come into focus. This question covers coordination with international organisations and other DFIs. China's DFIs, therefore, are at a critical juncture and it is important for global powers that have a wealth of knowledge and experience to make use of multi-national platforms such as the G20, to encourage China to participate in an international cooperation framework. Bilateral engagement would also be important.

For example, Japan is promoting third-country market cooperation with China, with the condition of the use of global standards to secure "bankability". Although Japan has not formally recognised the BRI, such efforts would be an effective use of Japan-China cooperation to engage China at various levels, including through its fiscal authorities and policy-based financial institutions.[9]

> "China's DFIs have produced projects that lacked "bankability", elements of which are debt sustainability and legal compliance."

The United States

A new trend in DFI is emerging from the United States. The US's key DFI is the Overseas Private Investment Corporation (OPIC), established in the 1970s as a spin-off of the US Agency for International Development (USAID) but which has not built for itself a strong presence globally. In 2018, amidst the growing geopolitical tensions between the US and China, as well as the aforementioned moves by Europe and China to strategically leverage their DFIs, the US Congress passed the BUILD Act to strengthen the US's DFI.[10] At the end of 2019, the US Development Finance Corporation (USDFC)[11] was established in accordance with the Act.

The USDFC has taken over the functions of OPIC related to loans and political guarantees, as well as some of the functions of USAID. It has additional functions such as equity investment, and doubling the maximum exposure amount from US$ 29 billion to US$ 60 billion. The USDFC is expected to be an important economic tool in the US government's efforts to promote its vision of a "free and open Indo-Pacific", and embodies the trend of countering China's geoeconomic approach while also incorporating the European trend of using equity investment.

The USDFC is also accelerating efforts to coordinate with other DFIs. In April 2019, the USDFC, EDFI, and FinDev Canada, a Canadian DFI, created the DFI Alliance,[12] a platform for international DFI coordination. The Alliance shortly issued a joint statement announcing collaboration in extending assistance to the healthcare sector of developing countries affected by the COVID-19 pandemic.[13] Based on the joint statement, the USDFC announced the Health and Prosperity Facility in May 2020. Drawing on developments in Europe, the USDFC is creating a trend in financial support for the global agenda of responding to the COVID-19 pandemic—one in which the US aims to lead—while also actively engaging other DFIs.

The USDFC is also seeking to coordinate DFIs in ways that complement its regional efforts. For example, it is looking to expand its presence in the Indo-Pacific region and is strengthening partnerships with the JBIC, as well as with the Australian government and other Japanese government agencies.[14] Large economies, including Japan, will need to strategically respond to this trend of coordination among DFIs. Moreover, even during the transition period in the US from the Trump to the Biden administration, USDFC and JBIC signed an MOU in January 2021 to further develop their existing cooperation.[15] The MOU extends the cooperation from the Indo-Pacific to other regions—this will energise the developing countries that have been affected by COVID-19.

The market is also beginning to make active use of DFIs. In January 2020, JPMorgan Chase announced the establishment of the JPM DFI.[16] The initiative will provide investors with financial products that contribute to the SDGs by measuring the development effects of the financing originated by JPMorgan using an analytical framework developed by an international organisation. This responds to the recent growth in investor appetite for ESGs and SDGs. JP Morgan intends to mobilise investors' funds by strengthening cooperation with international organisations and DFIs in various countries. While DFIs have contributed to the mobilisation of private capital by taking risks that have been difficult for their private-sector counterparts, JPMorgan's initiative is a new approach: it proactively utilises DFI functions that have been taken on by public institutions from a private-sector business perspective.

Due to the COVID-19 pandemic, the global agenda has expanded to include issues such as the sustainable health and safety of consumers, employees and local communities, as well as climate action. Traditionally, green bonds have been at the forefront of sustainability-focused financing, but international organisations are increasingly issuing social bonds to address financial disruption caused by COVID-19.[17] Investors are expecting a holistic ESG approach, which includes dealing with business partners and local communities, as well as social considerations and governance. In this context, market expectations of DFIs are expected to increase. Consumers and investors—especially the younger generation who may be more sensitive to sharing social responsibility—are expected to focus on the economic aspects of ESG investment, including the long-term benefits to people's lives.[18]

> "Green bonds have been at the forefront of sustainability-focused financing; today social bonds are being used to address Covid-induced financial disruption."

Strategic Cooperation

In summary, various countries are strengthening their DFIs, diversifying their financial products, and strategically developing their coordination with other countries' DFIs. They are doing this for many reasons, including to secure leadership in the global agenda, increase the international competitiveness of their industry, expand their geopolitical and geoeconomic influence, and support the development of low-income and emerging countries. As the global situation is changing rapidly, it is also becoming increasingly important to be agile and responsive.

As discussed briefly earlier, in response to the COVID-19 pandemic, the DFI Alliance of Europe, and the US have been quick to issue aligned messages, and the USDFC has been expanding its support to the healthcare sector. In May 2020, the USDFC created the COVID-19 Rapid Response Liquidity Facility for existing lending projects.[19] In addition, the US government issued an Executive Order under the Defense Production Act authorising USDFC to support domestic production of strategic materials on a two-year timeline in order to respond to the COVID-19 crisis and ensure the resilience of the domestic supply chain.[20] This is a new effort in addition to the USDFC's existing operations and represents a flexible expansion of financial support to "toughen up" projects and domestic-related industries.

Going forward, it is expected that expanding DFI risk-taking capabilities will be important in the economic recovery stage from the COVID-19 pandemic. For example, the UK CDC created the Catalyst Portfolio in 2017 to address high-risk lending,[21] and Nick O'Donohoe, CEO of CDC, has indicated its intention to utilise the portfolio strategically in the recovery stage.[22]

Each country is preparing a multifaceted menu of financial support in response to the crisis, from the perspective of economic recovery and industrial support. Indeed, countries need to make nimble use of their own DFIs and strengthen coordination between these institutions and other DFIs and international organisations. As each DFI has a different financing menu, the coordination on specific projects would be a challenge in terms of support for each other's industries and companies.

It would be one idea to advocate for broader coordination, as in the joint statement by the DFI Alliance in response to COVID-19, with each institution providing specific financial support under that arrangement. It would be even more effective if they also strengthen their cooperation with private financial institutions in terms of mobilising private capital. The Blue Dot Network (BDN),[23] for example, which is developed by the US, Australia and Japan, is also an important effort of DFI collaboration. It includes a project certification platform to promote quality infrastructure projects, and is intended to incorporate existing global standards, such as the G20 Principles for Quality Infrastructure Investment,[24] to mobilise private capital. As the BDN's effort for mobilising private capital is in line with the concept of the aforementioned JPM DFI, this will be highly anticipated by the private players. The DFI needs to strike a balance between the international competitiveness of its own companies, geopolitical and geoeconomic approaches, and the growth goals of developing countries. It also needs to create a new ecosystem that can respond flexibly to each of these aspects.

> "Expanding the risk-taking capabilities of DFIs will be important in post-pandemic economic recovery."

New DFIs in India

Given past experience, the role of Indian DFIs (IDFIs) is always surrounded with questions, despite having clearly defined mandates to spur growth in the infrastructure and industrial sectors. This happens due to governance factors that IDFIs have always grappled with. In the 1990s, following liberalisation and a spurt in economic activity, IDFIs suffered huge Non-Performing Assets (NPAs) and failed in various crucial areas. IDFIs had also inherited a bureaucratic culture that has impeded the achievement of their founding objectives. Judged in these terms, although the amounts of funds that flowed through these channels were huge, IDFIs failed to create dependable resources by way of funds and skills to accelerate the tempo of industrial and infrastructure development.[25]

In the 1990s, the Narasimham Committee on Financial Sector Reforms noted that the IDFIs may not be viable, since these institutions were raising funds at current market rates and lending to businesses with long gestation and there is often high risk of failure with high credit cost. Accordingly, the IDFIs were converted either into banks or Non-Bank Financial Institutions (NBFCs), subject to the full rigour of RBI regulations as applicable to the respective categories. Thus, while both Industrial Credit and Investment Corporation of India (ICICI) and Industrial Development Bank of India (IDBI) were converted into commercial banks, the Industrial Finance Corporation of India (IFCI) was converted into an NBFC.

India's Finance Minister Nirmala Sitharaman, in her 2021 budget speech, spoke about the need for a specialist DFI to channel funds to the INR1-trillion worth of infrastructure projects planned over the next five years. Since then, there have been calls to consider a 'New India DFI' (NIDFI).

In a media interview in December 2020, Debasish Panda, Secretary of Financial Services at the Ministry of Finance, had stated, "We need a development financial institution as infra[structure] financing needs patient capital, and banks are currently not suited for lending for long term projects which do not generate any cash for years."[26] Tarun Bajaj, Secretary of Economic Affairs at the Ministry of Finance, has also said that a NIDFI is needed and progress should be expected in the coming months.[27]

The NIDFI is expected to be partially owned by the government. The government is also looking at subsuming a smaller non-banking financial company, the India Infrastructure Finance Company (IIFCL), with NIDFI. The new entity will be given the mandate to fund large rural infrastructure projects that banks and other lenders are wary of funding due to their long gestation period.[28]

It appears that the NIDFI model will be initially risk capital, which will then be used to mobilise additional resources from development agencies such as World Bank, stepping in to co-fund NIDFI. At the same time, pension and sovereign wealth funds, too, will contribute in terms of investment, which will help NIDFI tap international capital markets with debt instruments. Further, the government may also announce certain steps to revamp the bond market to finance infrastructure projects at a time when the government expects its INR 111-trillion National Infrastructure Pipeline to cushion the blow to the economy by boosting investment. NIDFI could build with agreed sets of principles for creating buy-in for innovative financing mechanisms, introduce blended finance, adopt a portfolio approach in which a number of projects are aggregated for a broader funding participation, greater collaboration with last-mile players.

However, the work of DFIs is not likely to get easier, in the aftermath of COVID-induced economic disruptions and development imperatives while it presents interesting opportunities for the Indian economy. Leveraging the aforementioned global trend of international coordination among DFIs, the Government of India can collaborate with other experienced foreign DFIs such as JBIC, which has been increasing its strategic presence in India in recent years, in enhancing capacity building and nurturing a nascent institution since its beginning.

In 2020, for example, amidst the onslaught of the COVID-19 pandemic, the JBIC undertook proactive operations in India. In March, JBIC signed a loan agreement amounting to approximately US$ 3,087 million (JBIC portion)[29] to finance part of the funds required for Nippon Steel Corporation, in partnership with ArcelorMittal S.A. of Luxembourg, to acquire Essar Steel India Limited which once had gone insolvent in 2017.

India must now expand the scope of its cooperation with DFIs to include infrastructure development in third countries, particularly in the Indian Ocean and African counties, in addition to domestic development. Furthermore, India should actively participate in global infrastructure cooperation frameworks such as the BDN currently led by the US, Australia and Japan. Such financing collaborations could enhance future Quad cooperation, which is currently more focused on security.

> “In the 1990s, following liberalisation, Indian DFIs suffered huge NPAs and failed in crucial areas.”

National Infrastructure Pipeline (NIP)

In April 2020, the task force under the Ministry of Finance on National Infrastructure Pipeline (NIP) submitted its final report to the Finance Minister.[30] The task force forecasts an investment need of INR 111 trillion over the next five years (2020-2025) to build infrastructure projects and drive economic growth. The task force was set up after the Prime Minister, in his Independence Day speech of 2019, promised to roll out an infrastructure push worth INR 100 trillion over five years to make India a US$ 5-trillion economy.

The report has also suggested[31] ways and means of financing the NIP through the following: deepening Corporate Bond markets, including those of Municipal Bonds; setting up Development Financial Institutions for infrastructure sector; and accelerating monetisation of infrastructure assets and land monetisation. Under the NIP, the National Investment and Infrastructure Fund (NIIF) manages assets of US$ 4.3 billion across its three funds: Master Fund; Fund of Funds; and Strategic Opportunities Fund. The overall size of the Master Fund has reached US$ 2.34 billion and NIIF also announced the final close of this Fund,[32] which invests in operating assets in core infrastructure sectors, primarily transportation and energy.

NIIF has launched fundraising for Strategic Opportunities Fund (SOF), which will focus on sectors that offer growth opportunities and on building large-scale infrastructure debt financing business. It will have a Rupee equivalent target corpus of US$ 2 billion, making the SOF one of the largest India-focused private equity funds in the world. SOF has set up a Debt Platform comprising an NBFC Infra Debt Fund and an NBFC Infra Finance Company. NIIF, through its SOF, owns a majority position in both the companies and will continue to support them apart from investing in other suitable investment opportunities.

To catalyse debt funding of infrastructure projects, the Government of India in 2020 approved a proposal to infuse INR 60 billion in NIIF's debt platform,[33] aiming to enable the two NIIF-sponsored incorporated entities to raise INR 1 trillion in debt over five years. This process will also help relieve exposure of banks to infrastructure projects and free up space for new green-field projects. NIIF is supposed to make strong efforts to use the equity investments by the government to catalyse equity investments by Domestic and Global Pension, Insurance, and Sovereign Wealth Funds in NIIF Infrastructure Debt Financing Platform. Strengthening the IDF / take-out financing space in the infrastructure sector will enhance liquidity of infrastructure assets and lower risks.

Conclusion

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Expectations for DFIs in development finance are high, and Europe, the US, China, and Japan are exploring the strategic use of DFIs. The private market is also trying to use DFIs to enhance ESG investments, in particular.

In India, the use of DFIs is still in its nascent stage. However, it is expected that the country will utilise cooperation with overseas DFIs, such as Japan's JBIC, to enhance its presence in overseas infrastructure, in addition to strengthening support for domestic infrastructure. In particular, amidst rising geoeconomic risks, cooperating with allies, especially in efforts for recovery from COVID-19, and establishing India's DFIs should also widen the scope of India's international cooperation.

> The use of DFIs in India is still nascent; the country should utilise cooperation with overseas DFIs to enhance its presence in overseas infrastructure.

(All views, positions, and conclusions expressed in this publication should be understood to be solely those of the author.)

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