Key elements of an EU position for the UN FFD thematic debate

13/11/2014 Session on private finance and blended finance

1. Context

Private sector has been recognised as a key driver for growth and thus pivotal for development, but there are different perceptions in the UN about bringing private finance into the discussions. It is fundamentally different from public finance and seen by some as diverting attention from public action. It will be important to approach private sector mostly through the government prism of what actions (good regulation, leveraging) are needed to incentivise private finance to contribute towards public goals.

2. Overall issues on the session on private finance and blended finance

- The key for maximising the contribution of private sector to sustainable development is for governments to create a conducive climate that supports private participation in line with sustainable development objectives and criteria. . This includes targeted use of public resources to invest in areas that catalyse private investments towards policy priorities. To complement domestic action, all countries should together ensure an international policy environment of transparent and equitable rules, including on trade and financial markets.
- Responsible private sector partners could also take upon themselves to follow the principles of good corporate social and environmental responsibility, thereby contributing to the objectives of positive economic, environmental, social and governance impact and moving to an inclusive green economy. This should include assessing the impact of investments on policy goals, following the arm's length principle in transfer pricing, providing transparency on their activities, and adhering to international CSR and investor guidelines. Governments will need to decide on the appropriate balance between voluntary mechanisms and regulation to achieve the objectives.
- Using public finance to leverage private sources is a tool that can be useful for creating mutual benefits. Blending, which combines grants with loans or equity from other public and private financiers, is considered as one of these vehicles, along with public-private partnerships and other tools for leveraging additional resources. The strategic use of a grant can mobilise additional financing for projects with a high economic, social and environmental return, by addressing factors that hold back investment or setting the right incentives. Such actions need to be based on the project level assessment of the public benefits from this modality.

3. Key points on specific issues

i) Inclusive finance, including SME financing

- Lack of access to capital and appropriate financial services is a major constraint in particular on the development of micro, small and medium-sized enterprises. The wider access to a diversified set of financial services both for households and micro, small and medium-sized enterprises is fundamental. It can happen through interventions ranging

from capacity strengthening of financial intermediaries to the provision of capital; use of information and communication technologies (ICTs) as a tool for achieving financial inclusion of the poor; development of customer-centric models to promote inclusive credit, savings, insurance and payment services; creation of an appropriate financial infrastructure and regulatory framework for the financial sector to ensure customer protection, responsible finance and the long-term stability of the financial system. Governments should agree to create the necessary national environment for such development, including transparent management of natural monopolies.

ii) Long-term investment

- Productive investments across all sectors of economies in developing countries are tied to long gestation periods and longer repayment schedules, as indeed, many projects would not be viable otherwise. The result of long-term investments is expansion of countries' productive capital stock in manufacturing, agro-processing, etc. Financial sectors in developing countries are characterised by a lack of long-term lending on affordable terms, particularly for smaller companies. Limited and costly access to basic financial services remains a major obstacle to the healthy development of private sector activity, especially for MSMEs.
- Governments will need to reduce the regulatory and political risks that are now a key limitation to the participation of institutional investors in long-term projects. Guarantee and insurance mechanisms, as well as regulations governing the investment obligations of e.g. pension funds or sovereign wealth funds should be reviewed for reducing the current financial market imperfections, to allow the long-term investors invest in long-term assets.

iii) International capital flows

- Foreign Direct Investment and portfolio investments, as well as private international borrowing are key elements of integration to global markets and of technology transfer. As both a channel and an indicator of strong economic activity, it needs to be facilitated. At the same time, they entail risks (e.g. cyclicality), and their present quality leaves a lot to be improved in terms of their sustainable development impact. Thus governments need to ensure a regulatory environment that fosters both domestic and international private investment that support sustainable development, while insuring against the risks inherent in these type of flows.
- In economies that make de facto use of hard currencies (usually the USD) and where there are significant export-oriented activities in the country's sectors with revenues tied to internationally priced commodities, the demand for long-term investment in foreign currency is usually high. However, long-term investments in local currency are highly requested by the SMEs. When companies borrow in the currency in which they earn revenue, they are protected from foreign exchange risk, and can focus on expanding and creating more jobs**.** Innovative instruments offering the possibility of exchange risks hedging in developing countries should be developed.

iv) Sustainable finance

- Sustainable finance is the practice of creating economic and social value through financial models, products and markets that are sustainable over time. In addition to be financially viable, the investments shall lead to sustainable outcomes, meaning that the results achieved must be economically, socially, and environmentally sustainable and fully integrate climate change considerations. Governments should establish a regulatory environment that discourages unsustainable investment and encourages the sustainable kind. The state owned companies could be turned into role models for sustainable development, e.g. in terms of sustainability reporting and sustainability goals.

v) Local capital market development

- Developing local capital markets should be a strategic priority for governments. Deep, efficient local capital markets are the foundation for a thriving private sector, the key driver of jobs and growth. Local capital markets create access to long-term, local-currency finance. Lack of access to infrastructure services also limits private sector growth. Local capital markets can mobilize funds to finance infrastructure, housing, and other priority sectors. Countries with strong local capital markets are more resilient to economic crises. Efficient local capital markets protect economies from capital flow shocks and reduce dependency on foreign debt.

vi) Public private partnership (PPP)

- Partnerships between the public and private sectors for the purpose of delivering a project or a service traditionally provided by the public sector can be an effective means of making the supply of public goods and services to poor people more reliable and affordable, while complementing government resources with private sector investment. PPPs can provide innovative solutions in many areas, including renewable energy, green buildings, or other infrastructure services such as water and sanitation, waste management and transport. They can also be very useful in skills development and the provision of basic services, such as access to health care, and education, as well as in the areas of agriculture and nutrition especially in rural areas, to women and other excluded groups.
- The use of PPPs should be decided for each project on the basis of the analysis of public benefits of the modality. For that, countries should seek to reinforce their administrative capacities, and set up legal and regulatory frameworks and guidelines for PPPs, promote public-private dialogue mechanisms complemented by efforts aiming at improving expertise, transparency and governance in the public sector to ensure that the profit incentives of private actors coincide with public interests.

vii) Remittances and private development assistance

- Remittances are a significant private flow and account for a large share of GDP in several countries. A reduction in the cost of transferring remittances would bring significant benefits. Both sending and receiving countries should adopt policies that create competitive and transparent market conditions, provide access to better financial services and encourage a more informed and productive use of remittances.

- Private giving has increased significantly and plays an important role in specific communities and on several issues. To increase the effectiveness of such actions, these providers could also follow the international principles.

4. Additional issues the EU wishes to cover

Blending

- Combining grants with loans, equity or other risk sharing mechanisms from public and private financiers is an important vehicle for leveraging additional resources for development and also increasing the impact of aid. The grant can be used to address factors holding back the investment and improve a project's quality, sustainability and developmental impact. Blending is one implementation instrument complementary to others, used in accordance to the specific country or sector context.
- Through the EU Platform for Blending in External Cooperation, the EU is working together with Finance institutions on increasing the catalytic effect of blending in crowding in more private financing through greater use of financial instruments such as guarantees, equity and other risk-sharing instruments. The EU is exploring options to expand the scope of blending in new areas such as sustainable agriculture and to facilitate more projects with a strong impact on local private sector development like SME access to finance.

Impact financing

- More attention should be given to the financing of female entrepreneurs, to impact financing for social businesses and high-impact investments, as well as to improving access to loan and equity financing for SMEs referred to as the 'missing middle', as their financing needs typically are not met by either microfinance institutions or traditional banks.