Preparatory Process for the
third International Conference on Financing for Development
Substantive informal session: "Private and Blended Finance"

13 November 2014, Trusteeship Council Chamber, United Nations, New York

Private resources are a key driver of domestic growth and job creation. However, the 2008 financial crisis showed the risks associated with some forms of private investment. A special concern in the context of sustainable development is that adequate resources be directed into appropriate long-term investment. This concern impacts not only planning traditional infrastructure investments, but financing capital formation more generally, requiring policy oversight to encourage investment that reduces poverty and social exclusion, provides decent work for the nation, raises real incomes, and ensures environmental sustainability.

The challenge for policy makers is to remove inappropriate policy distortions and introduce effective market incentives. An enabling environment is essential for reducing risks and encouraging private investment. In addition, this can entail selective, well-targeted "smart" subsidies to private actors, such as through national development banks. It will often involve combining public and private action in both traditional (e.g., selling bonds to private investors to finance public water works) and innovative ways (e.g., marketing securities backed by a diversified portfolio of "green" projects). However, it is important to learn from the successes and failures of the past – and in particular avoid transferring risk to the public sector while maintaining high returns for the private partner.

Governments can also work to develop local capital markets and financial systems for long-term investment, within a sound regulatory framework that is aimed at balancing stability with access to credit and other financial services. Such policies need to be based on an understanding of both the strengths and limitations of the private sector, and of the underlying mandates and incentives of different investors and financial intermediaries.

Programme

Substantive informal session: "Private and Blended Finance"
13 November 2014, Trusteeship Council Chamber, United Nations, New York

Co-Chairs: H.E. Mr. George Wilfred Talbot (Guyana)
H.E. Mr. Geir O. Pedersen (Norway)

Session 1:
10.00 a.m. to 1:00 p.m.: Exploring the nexus between financial sector development, financial inclusion and financial stability

Moderator: Ms. Marilou Uy, Executive Director, G24 Secretariat

- Ms. Leora Klapper, Lead Economist in the Finance and Private Sector Research Team of the Development Research Group, World Bank
- Ms. Claire Walsh, Senior Policy Analyst, J-PAL, MIT
- Mr. Henri Dommel, Director Inclusive Finance Practice Area, UNCDF
- Ms. Chuchi Fonacier, Managing Director, Bangko Sentral ng Pilipinas
- Mr. Peter Graves, Senior Vice President, World Council of Credit Unions
- Mr. Dilip Ratha, Lead Economist, Migration and Remittances, World Bank

Session 2:
3.00 p.m. to 6:00 p.m.: Long term finance for sustainable development
Moderator: Ms. Shari Spiegel, Chief, Policy Analysis and Development Branch, FFDO, UN-DESA
Panel 1: International capital flows, long term investment, and blended finance

- Mr. James Zhan, Director of the Investment and Enterprise Division, UNCTAD
- Mr. Gavin Anderson, Executive Counsellor, Banking, EBRD
- Mr. Magnus Eriksson, Chief Investment Officer, AP4 (Swedish Pension Fund)
- Mr. Jesse Griffiths, Executive Director, EURODAD
- Mr. Sachin Rudra, Chief Investment Officer, Acumen

Panel 2: The potential of ESG initiatives to increase long-term investments into sustainable development

- Mr. Steve Waygood, Chief Responsible Investment Officer, Aviva
- Mr. Magnus Eriksson, Chief Investment Officer, AP4 (Swedish Pension Fund)
- Mr. Georg Kell, Executive Director of the UN Global Compact
- Mr. Elliot Harris, Director, New York Office United Nations Environment Programme and Head of Secretariat, UN Environment Management Group

Private and Blended Finance
Briefing Note

In understanding the role of the private sector in financing sustainable development, it is important to recognize that the private sector includes a wide range of diverse actors, from households to multinational corporations and from direct investors to financial intermediaries, such as banks and pension funds. While the predominance of private finance is profit driven, a growing number of institutions have double (social) and triple (social and environmental) bottom lines. Nonetheless, the private sector is unlikely to invest sufficiently in public goals and in important areas of sustainable development when expected returns are not competitive with other opportunities. However, private resources are a key driver of domestic growth and job creation and the private sector plays an important role in development.

Exploring the nexus between financial sector development, financial inclusion and financial stability

The Monterrey Consensus recognized the role of the private sector in development and emphasized the need "*to strengthen and develop the domestic financial sector, by encouraging the orderly development of capital markets through sound banking systems and other institutional arrangements aimed at addressing development financing needs.*" It also recognized the diversity of the private sector and suggested that "*Microfinance and credit for micro-, small and medium-sized enterprises, including in rural areas, particularly for women, as well as national savings schemes, are important for enhancing the social and economic impact of the financial sector. Development banks, commercial and other financial institutions, whether independently or in cooperation, can be effective instruments for facilitating access to finance, including equity financing, for such enterprises… In addition, the promotion of private-sector financial innovations and public-private partnerships can also deepen domestic financial markets and further develop the domestic financial sector.*"

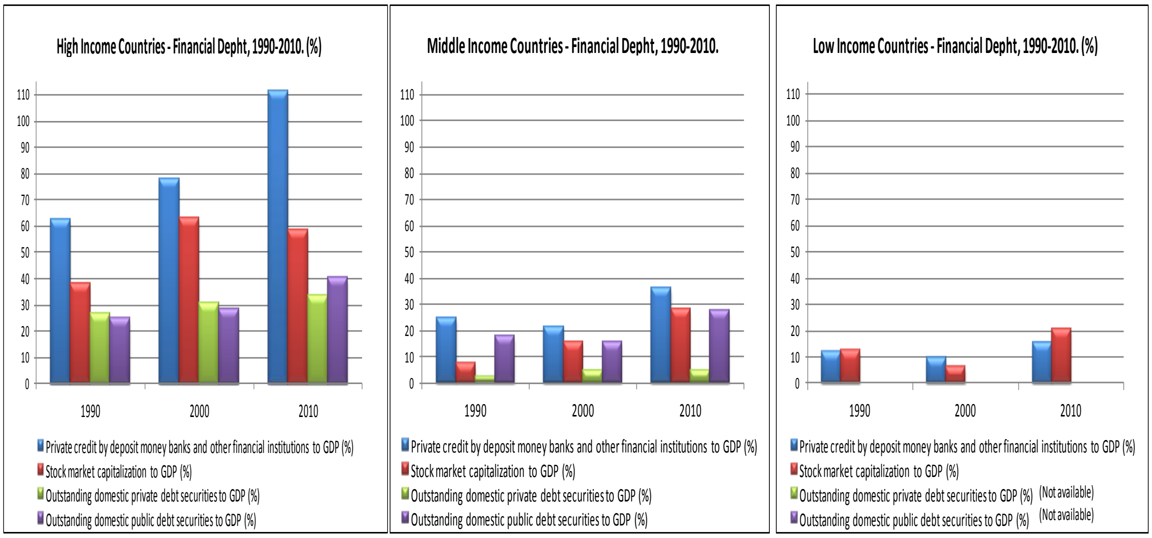
Indeed, there has been enormous change since the Monterrey Consensus. From 2000 to 2013, the ratio of private credit to GDP increased from an average of 19 per cent to 33 per cent in low-income countries, and from 52 per cent to 82 per cent in middle-income countries. Nonetheless, in many developing countries, especially low-income countries, financial markets remain underdeveloped, and financing has been insufficient to meet sustainable development needs.

In particular, in many countries, credit is primarily short-term. For example, in some countries in Africa, short-term credit accounts for up to 90 per cent of bank financing,[1] vs. 50-60 per cent for developing countries as a whole.[2] Long- term bond markets are limited in many developing countries, and alternative vehicles for financing innovative start-ups, such as angel investors and venture capital funds, are largely missing in many developing

[1] K. Kpodar and K. Gbenyo, *Short- Versus Long-Term Credit and Economic Performance: Evidence from the WAEMU*, IMF Working Paper, WP/10/115, May 2010.
[2] BIS database

countries. This is particularly problematic in that small and medium-sized enterprises (SMEs), which in most countries are main drivers of innovation, employment and growth, have insufficient access to finance. Approximately 200 million enterprises in emerging markets lack adequate financing and financial services. National development banks (NDBs) can play an important role here. Some countries have sought to promote access to finance for SMEs through a calibrated interplay of private and public banks.

Depth of selected financial system components by income groups, 1990-2010 (%)[3]



Source: ECLAC, Financing for Development Division on the basis of Global Financial Development Database, World Bank, April 2013.

Higher income countries have deeper and more complete financial systems. In higher income countries public bonds outstanding stood at a level of 40 per cent of GDP on average as of 2010, while private bonds are at 34 per cent of GDP. By contrast, in middle income countries bond markets are clearly dominated by sovereign bond issues, and are little used as a funding source by most private companies, while these markets are minimal in low income countries. On average, private debt securities were only 5 per cent of GDP in middle income countries, compared to 34 per cent in high income countries in 2010. Similarly, the depth of equity markets stood at nearly 60 per cent of GDP in high income countries; in low and middle income countries it amounted to only 20 and 28 per cent respectively.[4]

The lack of long-term bond markets limits the availability of long-term financing in many countries. Deeper capital markets should provide a conduit for the long-term investment necessary for sustainable development. Nonetheless, there is a risk that such nascent markets will attract speculative capital, leading to short-term bubbles and shocks to the real economy.

[3] The banking system depth is measured as the stock of private credit (by deposit money banks and other financial institutions) in percent of GDP, the equity market depth is measured by the stock market capitalization with respect to GDP and the domestic bond market depth is measured by the stock of outstanding domestic public and private debt securities, as a percentage of GDP.

[4] UNTT, Background Paper 2, 2013, based on the basis of Global Financial Development Database, World Bank

It is therefore important for countries to design a strong regulatory framework, potentially including capital account management tools.

Building a long-term domestic institutional investor base could help provide a stable source of investment finance. The presence of institutional investors in developing countries is still significantly lower than in high-income countries, though it has been growing. Emerging market pension funds are estimated to manage $2.5 trillion in assets, and are expected to increase significantly.[5] A sizable portion of these portfolios is invested in domestic sovereign debt. In some developing countries, though, national pension funds have also been investing directly in national or regional infrastructure, including in South Africa, Ghana, Chile, Mexico and Peru.

In most developing countries, building an institutional investor base will require upgrading expertise and skills, as well as reforms in licensing, portfolio requirements and changes to security laws. Good governance and an enabling environment are crucial for effective mobilization of domestic financial resources. Though more needs to be done, many developing countries have made progress in this respect, especially in the area of legal and regulatory reform. Nonetheless, even in developed markets, institutional investors, including pension funds, do not necessarily invest with a long-term investment horizon, as discussed below. Policymakers thus also need to consider measures to incentivize longer-term investment and investment in sustainable development. Overall, the regulatory framework should focus on the need to ensure long-term sustainable finance while reducing risks associated with short-term bubbles.

Financial Inclusion

Financial depth and financial inclusion are distinct dimensions of financial development, i.e. financial sectors can become deep without delivering access for large segments of the population. In the case of Vietnam, the financial sector exceeds the size of its GDP, but only 21 per cent of adults in the country report having a formal account. On the other hand, the Czech Republic, with financial depth less than that of Vietnam has an account penetration of 81 per cent.

Overall, more than half of the working-age adults in the world are currently “unbanked” by formal providers, with the vast majority in developing countries. Promoting financial inclusion requires concerted efforts of a wide range of stakeholders, including microfinance institutions, cooperative banks, postal banks and savings banks, mobile banking as well as commercial banks. In addition, new technologies are increasingly being used to reach the underserved communities. These same institutions, along with development banks, are also particularly well-suited to lending to SMEs.

There are various ways to promote financial inclusion. Some elements that have worked well across countries, including support for the development of credit bureaus for assessing borrower loan-carrying capacity. Developments in information and communication technologies can make it possible for poor people to receive financial services at low cost

[5]Inderst, G. and Stewart, F., 2014, *Institutional Investment in Infrastructure in Developing Countries: Introduction to Potential Models*, World Bank

without having to travel long distances to bank branches. Branchless banking and mobile banking technologies can be used in making Government-to-People payments (wage, pension and social welfare payments) with lower administrative costs and less leakages. Bringing more people into the formal financial sector is believed to also have a beneficial effect on tax collection. Furthermore, regulation is important to ensure responsible digital finance and avoid abusive practices.

Prudential regulation

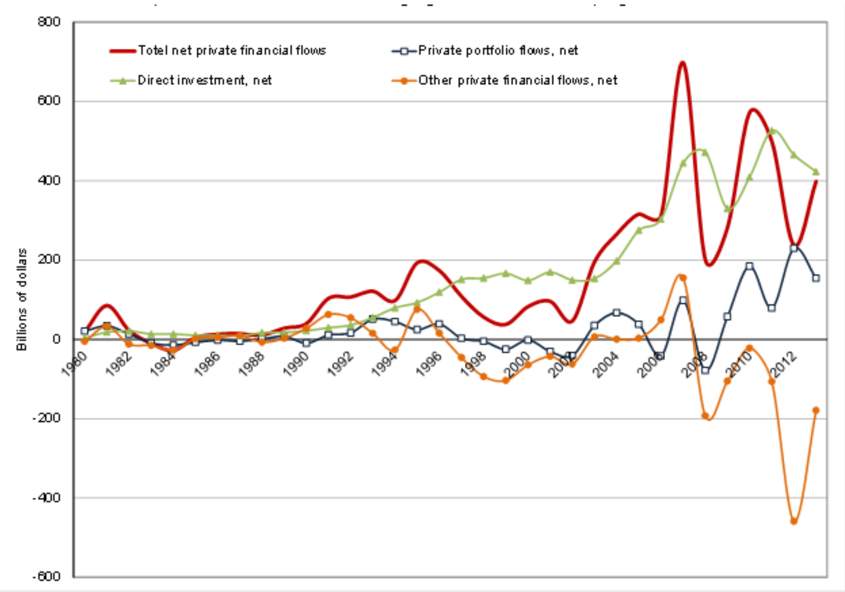
The emerging market financial crises of the 1990s, along with the recent global crisis, underscore the risks that the financial sector, including the shadow banking sector, can pose to the real economy. Thus financial market development needs to be built on a robust regulatory framework – in all countries. A robust framework should consider all areas of financial intermediation, including shadow banking ranging from microfinance to complex derivative instruments. In other words, financial regulation needs to look across the entire spectrum of domestic finance. Nonetheless, the design of regulation of many institutions needs to be done with care to avoid cutting off important efforts to widen financial inclusion. Enhancing stability and reducing risks while promoting access to credit presents a complex challenge for policymakers, since there can be trade-offs between the two. Policymakers need to design the regulatory and policy framework to strike a balance between these goals.

Long term finance for sustainable development

International capital flows, long term investment, and blended finance

There has been a strong upward trend in international private capital flows to developing countries over the last decade (with net private capital flows to developing countries increasing more than threefold from $180bn in 2003 to $367bn in 2013). However, the impact of this on sustainable development has been less clear. Private capital flows have not necessarily been invested in countries most in need and in sectors necessary for sustainable development, and have been subject to great volatility over the years, driven by trends in the global economy and by an increased tendency towards short-termism by investors.

Net Private Capital Flows to emerging market and developing economies[6]



Foreign direct investment (FDI) has exhibited the largest trend increase over the last decade, rising in net terms from $135bn in 2003 to 447bn in 2013 and has also shown greater stability. Overall FDI to developing countries has been limited to few countries and sectors particularly in Asia and Latin America. Although flows to Africa increased in the last decade, they remain limited. In addition, "greenfield" FDI to developing countries has fallen by more than 50 per cent since the crisis, signalling a potential reduction of the impact of FDI on the real economy and sustainable development. Although the value of announced greenfield projects to LDCs increased by 9 per cent in 2013, it remains significantly below historical levels.[7]

Cross border bank flows to developing countries have demonstrated particularly high volatility. A number of international banks – particularly in Europe – have continued to be saddled with financial difficulties, non-performing loans and deleveraging pressures. In particular, this has affected long-term financing for infrastructure projects in emerging market and developing countries, a significant portion of which had previously been provided by large developed country banks.

Portfolio flows also remain highly volatile. In 2013, net portfolio capital flows to developing countries (primarily from institutional investors) turned negative, as longer-term US interest rates rose. More broadly, most institutional investors continue to invest in liquid assets, often with a short-term investment horizon. Nonetheless, certain categories of institutional investors, particularly those with long-term liabilities (such as pension funds, life insurance companies, and sovereign wealth funds who hold around $60 trillion in assets) may be well-suited to undertake longer-term investments. One impediment to long-term direct investment by institutional investors is that many investors do not have the capacity to do the necessary due diligence to invest directly in infrastructure and other long-term assets. Instead, they

[6] Calculations by UNDESA based on IMF World Economic Outlook Database, April 2014, IMF Balance of Payments Statistics.
[7] UNCTAD, World Investment Report, 2014

make these investments through secondary financial intermediaries, whose incentives tend to be shorter- term. In addition, the incentive structure and related institutional arrangements even within the primary institutional intermediaries can also serve to discourage longer-term investment. Additional factors, such as mark to market accounting that require that long-term illiquid portfolios be evaluated relative to a public market benchmark may have also served to encourage short-term time horizons on the part of institutional investors.

The official sector can play an important role in incentivizing private flows in favour of longer-term investment, including in infrastructure, in green economy activities and in low-income and least developed countries. Over the last decade, public-private partnerships, equity investments, guarantees and insurance have become increasingly looked to as mechanisms for using official resources to leverage private financing through risk-sharing between the public and private sectors. However, it is important that such mechanisms learn from the successes and failures of the past – and in particular avoid transferring risk to the public sector while maintaining high returns for the private partner. Careful consideration needs to be given to the appropriate use and structure of blended finance instruments, while avoiding unnecessary liabilities for the public sector. In this regard, national, regional, and multilateral development banks have an important role to play.

The potential of ESG initiatives to increase long-term investments into sustainable development

There has recently been a renewed focus on corporate responsibility and sustainable development. Yet, despite some significant achievements and major breakthroughs, sustainable finance practices are still far from mainstream. Sustainable finance implies a shift in the financial sector to make sustainable development, including the three pillars of economic, social, and environmental stewardship, a central concern for the global financial sector. While the financial industries have traditionally focused on creating economic value, their short-term investment horizon has meant that they have often overlooked the long-term value of sustainable environmental, social and governance practices, and may have not given adequate attention to the long-term risks associated with neglecting them.

Nonetheless, there has been an increasing recognition on the importance of sustainability to long-term investing. In this regard, the term EESG (economic, environmental, social and governance) has also been used to better show the integration of the economic bottom line with social, environmental, and governance (or ESG) issues.

A number of sustainable finance initiatives have sprung up and expanded over the past 20-30 years, which have been aimed at changing investment criteria. Sustainable finance initiatives have typically embraced one or more of the following activities:

- Develop standards and principles to enable financial institutions to adopt sustainable practices in their core business strategies, operations, communications, products and services (e.g., Equator Principles for project financiers; Principles for Responsible Investment for investors; Principles for Sustainable Insurance for insurance companies).

- Research into how sustainable development issues can have a material impact on the financial sector (e.g., the impact of integrating ESG considerations on the fiduciary duty of pension fund trustees, on sovereign credit assessments, on insurance underwriting).
- Awareness raising and capacity building address the still limited knowledge and understanding within financial institutions and where expertise is concentrated in a small proportion of the industry's work force (e.g., UNEP FI's training for credit analysts to identify, assess and manage environmental and social risks).
- Public policy advocacy for a paradigm shift in financial markets, starting with financial regulatory change that includes sustainable development in policy goals, and more generally for economic policies to integrate environmental and social externalities and drive good governance practices.

Guiding questions

1. *What suggestions can be offered in striking a balance in regulations between risk and access from the experiences in developed and developing economies? Should prudential regulators and development policy makers come together to learn from each others' experiences?*
2. *What lessons have been learned from research and experience that should be recommended to policy makers for offering the "unbanked" access to essential financial services (payments, savings, credit and insurance)?*
3. *One particular area of international concern has been the high cost to safely transfer workers' remittances to families in home countries. What more is being done and should be done to meet the fund transfer needs of overseas workers?*
4. *Which policy incentives have been found most and least effective in extending the transformation of savings into long-term investment? What market incentives might increase the demand for long term funds? Is long-term and illiquid investment primarily a public interest responsibility, as for national development banks?*
5. *What role should insurance and guarantees play? How can private-public partnerships be designed so to raise additional resources for sustainable development while ensuring that the risks and returns are fairly shared? Should the international community develop guidelines for policymakers seeking to deploy blended financing? Might a multistakeholder effort in this regard be undertaken under the FfD process?*
6. *How should voluntary "ESG" or "EESG" initiatives be assessed? Do they require legislation to effectively guide investment decisions? How can ESG criteria be mainstreamed into the criteria used by investors, bankers and rating agencies?*