<u>Preparatory Process for the Third International Conference on Financing for Development</u>

Session 4: "Private and Blended Finance" (13 November 2014)

Informal summary by the Secretariat

Morning Session: "Exploring the Nexus between Financial Sector Development, Financial Inclusion and Financial Stability"

The panel was moderated by Ms. Marilou Uy, Executive Director, G24 Secretariat, and featured presentations by 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; Ms. Chuchi Fonacier, Managing Director, Bangko Sentral ng Pilipinas; Mr. Peter Graves, Senior Vice President, World Council of Credit Union; Mr. Dilip Ratha, Lead Economist, Migration and Remittances, World Bank; and Mr. Henri Dommel, Director Inclusive Finance Practice Area, UNCDF.

In her introductory remarks, the moderator, Ms. Marilou Uy, highlighted the need for the financial sector to contribute to the real economy. She encouraged speakers to explore the distinct dimensions of financial sector development as well as their interconnectedness.

Ms. Klapper highlighted four objectives financial sector development should pursue, namely financial depth, access to financial services, greater efficiency in credit intermediation and financial stability. While financial depth, measured as private credit to GDP, had been linked to economic growth, the state had an important role in providing consumer protections and enforcing a regulatory environment in support of financial stability. Likewise, as regards financial inclusion, the government and regulators should help promote access to financial services to underserved communities. Indeed, recent data gathered by the World Bank had shown that 2.5 billion people remained unbanked with women disproportionately affected. She emphasized the potential for innovative technologies to promote financial inclusion. In that context, regulators should nurture innovation and allow for competition from providers in alternative sectors, like mobile banking. Moreover, in addition to a sound legal and regulatory framework, government policies that promoted trust, competition and education were key for a more inclusive financial sector.

Ms. Walsh shared the outcome of randomized controlled trials on financial inclusion, and in particular microcredit and microsavings, in several countries. Based on the outcome of eight evaluations in seven countries, microcredit had shown no significant impacts on income and only minor positive impacts on business investment. However, microcredit had helped borrowers to smooth consumption and cope with risks and shocks. At the same time, it had a positive impact on nutrition and gender empowerment, as well as subjective wellbeing. On the other hand, microsavings products had a positive effect on wealth assets and income, although the positive findings were driven by a small proportion of active users, while the rest of the poor were still constrained. Overall, product design and diversity were important. Technological innovation mattered a great deal, For example, greater electronic payments in India had led to lower leakage of social transfers, faster payments, and promoted women empowerment.

Ms. Fonacier shared the lessons of the financial inclusion strategy in the Philippines. The challenges were enormous with 37 per cent of cities and municipalities without access to a banking office and services concentrated in high income areas. She stressed the need for an enabling environment and regulation. Inclusion could be a goal of the central bank alongside stability. Technological innovation was a key ingredient, since it made it possible to serve more people in real time with lower costs. In that context, the bank had followed a test-and-learn approach and had identified 27 banks and 5 non-banks that could deal with e-money. E-money was used for retail, but also government payments (conditional cash transfers and government pensions), as well as for disaster relief payments. Ms. Fonacier emphasized the need to regulate and supervise small financial institutions and e-money providers, in particular their capital adequacy, licensing procedures, governance and risk management. However, she highlighted the need to apply a proportionate approach to ensure that the required measures will be commensurate to the level of operations. She emphasized that it was possible to balance inclusion, stability, integrity and protection of consumers. Stable financial systems were only meaningful if they managed to serve the majority of people.

Mr. Graves highlighted that his organizations represented 208 million members of credit unions in 103 countries, as well as US$2 trillion in assets. While the number of credit unions in Africa, Middle East and Asia were smaller in terms of members and assets than other regions, Asia and Africa had a large numbers of very small credit unions. Credit unions were non-profit, democratically controlled organizations. Their non-profit nature would lead to cost savings on loans and better interest rates. While the focus was mostly on individuals/households, the challenge was to extend the loan portfolio to small and medium sized enterprises. Looking ahead, the speaker called for a comprehensive plan for financial inclusion, which should include credit union as successful institutions. There was a need for proper regulatory supervision and examination requirements, including accounting to constrain governance problems. New innovations like field agent banking, which promoted personalised financial management, should be further explored.

Mr. Ratha highlighted that remittances had reached US$413 billion last year. Remittances were more stable than FDI and could act as insurance for poor people. Remittances were linked to reduced school drop-outs rates, poverty declines and higher birth weights. The major challenge was to reduce the lending costs which had remained exorbitantly high (8 per cent costs on average at the global level, 12 per cent on average for Sub-Saharan Africa, and 30 per cent on average within Sub-Saharan Africa). The speaker recommended to relax global anti-money laundering (AML) and counter-terrorist financing (CFT) rules for remittances smaller than $1000, as well as to abolish exclusive partnerships with post offices – since this collaboration was stifling competition and served as a tax on poor people. Moreover, the creation of non-profit remittance platforms could disrupt the market and force change. Improvements in data collection and linking remittances to micro-health and micro-saving insurance were also crucial.

Mr. Dommel highlighted that UNCDF was one of the few UN agencies with capital – grants, loans, and equity investments. He emphasized that in most countries where UNCDF was present, national financial inclusion strategies were sound, but countries were lacking diagnostics and data. There was a need to work across ministries and with other stakeholders and to engage the private sector. The agency used its resources to help mobilise access on domestic savings products, which were more important than access to credit. Moreover, since its budget was relatively low, UNCDF was trying to use its limited resources in a catalytic way with the objective to leverage access to domestic commercial lending. For example, UNCDF managed to crowd in more than $100 million for its MicroLead Expansion

programme that targeted market leaders in microfinance in underserved countries. UNCDF also promoted SSC to bring equity investment into micro-savings institutions.

The subsequent interactive discussions included the following key points:

- Several participants emphasized that remittances are private economic transactions and conceptually very different from other sources of investment. It is misleading to refer to them as aid and they should not be seen as a substitute for aid.

- A large number of speakers underlined the need to reduce remittance costs. One representative noted his country had published the different costs of remittances online. This created competition and lowered remittance costs to 6 per cent.

- It was noted that Third International Conference on Financing for Development commitments could galvanize momentum for comprehensive financial inclusion strategies. Governments could lead the way by switching to digital financial payments. Such a move would increase transparency, reduce leakages and contribute to women's economic empowerment, since digitalized payments could help target women.

- With regards to randomized controlled trials, it was emphasized that the evaluation had focused on the impact of microcredit to households and was not focussed on micro manufacturing. Investments in small manufacturing might be much more effective because they could increase employment.

- Several participants emphasized the need to address gender disparities in the discussion on financial inclusion. Mobile payments could help where women could not access traditional banking institutions. Good disaggregated data on gender access and usage was seen as important. Moreover, balanced gender representation in the governance structures of financial institutions was important to influence their policies.

- There were calls for people-centred financial sector development. Financial sector policies should respond to social needs rather than corporate concerns and profitability. Moreover, appropriate regulations are needed to limit systemic risks and to ensure consumer protection without compromising financial inclusion.

Afternoon Session: Long-term Finance for Sustainable Development

The afternoon session featured two panels relating to mobilizing long-term finance for sustainable development. The first panel was on "International capital flows, long term investment and blended finance," and the second on "The potential of ESG initiatives to increase long-term investments into sustainable development". The session was moderated by Ms. Shari Spiegel, Chief, Policy Analysis and Development Branch, Financing for Development Office, UN DESA.

Panel 1: International capital flows, long term investment, and blended finance

The panelists were 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. Sachin Rudra, Chief Investment Officer, Acumen; and Mr. Jesse Griffiths, Executive Director, EURODAD.

The moderator, Ms. Spiegel, began by pointing out that, despite large financing needs, insufficient funds are flowing to areas pertinent to sustainable development, such as infrastructure, small and medium enterprises (SMEs) and innovation. This panel would assess the impediments to long-term private investment into these sectors.

The first panelist, Mr. James Zahn, provided an overview of trends in foreign direct investment (FDI) flows, and assessed their contribution to fulfilling investment needs for sustainable development. While developing countries' share of FDI has been increasing and recently reached 54 per cent of global FDI flows, it remains concentrated in a few countries. Moreover, FDI to least developed countries (LDCs), small island developing states (SIDS) and landlocked developing countries (LLDCs) remain at low levels. Mr. Zahn argued that there is significant potential for greater investment, not least due to the large cash holdings that have been accumulated by multinational corporations. Stressing the need to link foreign investments more closely with the development strategies of recipient countries, the speaker proposed a number of transformative actions to ensure that FDI flows to areas where they are profitable but also have a positive sustainable development impact. These included establishing investment promotion agencies that focus to a greater degree on sustainable development and ensuring a well-prepared pipeline of projects. Mr. Zahn also called for better policy coherence across a range of areas including those pertaining to trade, investment and competition.

Mr. Magnus Errikson stressed that markets have become highly focused on short-term returns, but that in contrast to many investors who tend to be short-term oriented, the Swedish Pension Fund is able to take a longer-term approach and operates with a 40 year horizon (with their managers evaluated over a 5 year period). This emanates from the mandate set by the Board, which is to contribute to the stability of the national pension system through managing Fund capital with the aim of generating the best possible return over the long term, as defined by the duration of the liabilities of the pension system. As a result of this longer-term horizon, AP4 has been able to take into consideration factors, such as sustainability, while at the same time having a commercial approach and working in the interest of pensioners. Nonetheless, AP4 is legally allowed to only allocate 5 per cent of their investments in unlisted equities. This allocation to 'illiquid' investments is primarily invested in real estate, which has made it difficult for AP4 to invest directly in other illiquid long-term assets, such as in infrastructure. They have also not been set up to undertake direct investments in emerging markets. Mr. Errikson noted that they would be interested in investing in long-term instruments (including equity and debt) that support investments by institutions and development banks, such as the facility described by Mr. Gavin Anderson from the EBRD, if structured in line with AP4's investment requirements.

Mr. Sachin Rudra explained that Acumen is an 'impact investor'. He stated that impact investing attempts to achieve both a financial return as well as social good. Thus, in contrast to most private sector firms, which focus solely on the financial return, Acumen provides patient capital that blends social and financial returns to achieve a long-term social impact. It tries to support social entrepreneurs by addressing the funding gap in early stage private enterprises. Many of their investments combine philanthropy with for profit investment. He cited the example of Acumen's investment in an enterprise in Bihar, India called 'Husk Power Systems' which took agricultural waste, rice husks otherwise left to rot, and converted it into gas that powers a turbine to generate electricity. The initial funding for 'Husk Power Systems' came from foundations, with additional financing from Acumen and more traditional venture

funds. Thus, while the process began with grant financing, as the company became more sustainable, more traditional finance was attracted. The company now has 84 plants in operation across Bihar, serving 300 villages and 225,000 people. He argued that while Acumen's size may be limited, their model of financing is scalable. However, he pointed out that while there is the possibility for innovative models that combine different aspects of finance in some areas, other activities only lend themselves to public finance.

Mr. Gavin Anderson emphasized that blending has been an important part of the EBRD's financing model, and the bank never takes a stake larger than 35 per cent in any of its investments. Blended financing has been used in a range of sectors where financing for sustainable development has been constrained, such as sustainable energy, infrastructure and SMEs. In addition to financing, the EBRD also work with donors and governments to help create conducive business environments. In terms of fund raising, the EBRD has worked with commercial banks and institutional investors, including pension funds and insurers, for investment in projects. Mr. Anderson also pointed out that while some blended finance projects may have been financed anyway by the private sector, the point to bear in mind is that the inclusion of public financing may have paved the way for different and more sustainable activities by the private sector.

Mr. Jesse Griffith emphasized that private investment cannot substitute for public investment, and that the focus on attracting private investment should be based on quality not quantity. He stated that the agenda of using public finance to leverage private capital needs a fundamental rethink. He emphasized that 80 percent of infrastructure spending in developing countries has been publicly financed. In order to continue to finance infrastructure, it is important to increase tax revenues through tackling tax evasion, tax avoidance and tax competition. In that regard, he pointed out that there is a need for a UN intergovernmental committee on international tax cooperation. Mr. Griffith also called for systemic reform of the international financial system that would enable developing countries to free up the resources that they currently use to build up international reserves for self-insurance and also reduce the likelihood of costly debt crises. He pointed out that private investments remain low in low-income countries and that FDI inflows have been volatile and concentrated in the extractive sectors. Mr. Griffiths emphasized that development finance institutions have been dominated by high-income countries and there is a need to focus on national development banks as an instrument for mobilizing finance for sustainable development. In general, he stressed that it is not appropriate to use ODA for leveraging private finance and that PPPs have by far been the most expensive form of financing.

A number of points were made during the interactive discussions, including the following:

- It was emphasized that it is important to define what blended financing means. Some participants suggested that PPPs often end up being a debt instrument where the only revenue stream flows from governments to the private investor. It was stressed that PPPs should be structured to ensure that the government does not take most of the risks, while the private sector retains the returns. There was also a discussion of the added value of blended finance projects, with a speaker arguing that even if these projects would have happened anyway, they would have happened differently in the absence of public/private cooperation. The key is to differentiate between effective and ineffective blending.

- A participant stated that the targeted use of ODA can serve to effectively leverage private investments, though others warned against the use of ODA for this purpose. It

was suggested that ODA can also leverage private finance indirectly through enhancing project preparation and capacity building.

- There was some discussion of the volatility and impact of FDI flows. It was argued that while a large amount of FDI earnings flow out as repatriated earnings, a significant amount still remains in the host countries and is reinvested.

- A delegation pointed out that a fraction of the investments made by sovereign wealth funds could, if channeled to sustainable development, have a significant impact. On the other hand, it was mentioned that sovereign wealth funds are generally profit oriented, and are not channeled to areas where the risk/return profile is not favorable. It was pointed out that very few sovereign wealth funds invest directly in long-term investments. For a start, their managers lack the expertise to undertake longer-term investments. It was also noted that the majority of sovereign wealth funds are hosted in developing countries. Some participants suggested that sovereign wealth fund investments are to a greater degree undertaken in the framework of South-South cooperation.

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

The panelists were 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; Mr. Steve Waygood, Chief Responsible Investment Officer, Aviva; and Mr. Magnus Eriksson, Chief Investment Officer, AP4 (Swedish Pension Fund).

Mr. Georg Kell asserted that there was a quiet revolution happening in the business community. In particular, the business world is changing due to an increase in transparency, with markets increasingly taking a longer-term horizon on investments that underpin future growth rates. The speaker emphasized the importance of voluntary initiatives by companies to integrate sustainability criteria into business decisions, but pointed that more needed to be done in this respect and that the Global Compact has excluded many companies for not disclosing their activities sufficiently. On a positive note, he stressed the importance of the Principles for Responsible Investment initiative,[1] which has been signed on by institutional investors managing 45 trillion dollars. Mr. Kell underscored the importance of incorporating ESG criteria into companies' investment decisions. He pointed out that the transformation of decision-making along these lines is not yet at a tipping point but that it is a matter of time before this movement becomes more important.

Mr. Elliott Harris stated that the UNEP Finance Initiative (UNEP-FI) is a partnership between UNEP and institutional investors, which aim to see how ESG can impact financial decisions, and how financial sector participants can contribute to sustainable development. Over 200 institutions, including banks, insurers and fund managers, work with UNEP to understand the impacts of environmental and social considerations on financial performance. He mentioned that UNEP-FI had a training program for institutional investors on ESG. They have also engaged with financial regulators to see how their regulations affect sustainable development. Mr. Harris also pointed out that governments have an important role to play in setting incentives (shifting the balance between non-sustainable and sustainable activities), requiring

[1] This is an international network of investors working together to put six principles for responsible investment into practice. The initiative was formed in partnership with the UNEP Finance Initiative and the UN Global Compact.

disclosure, preparing bankable sustainable projects. He mentioned that there are many initiatives under way that require companies to make disclosures, but there is an insufficient degree of standardization.

Mr. Steve Waygood explained that in his view the current structure of the financial system undermines sustainable development, and that there is a need to change this through encouraging the integration of ESG issues into investment criteria. He suggested that there are a number of ways to do this. First, there is a need to change price signals to ensure that externalities are internalized to improve the readiness of investors to integrate sustainability issues. In addition, there is a need to change incentives within the system to make shorter-term time horizons less rewarding for investors. He suggested that capital markets incentivize short-term behavior. In this regard, he described the flow of funds through a chain of financial intermediaries, and explained the short-term incentive structures throughout the chain. Changing this could involve reshaping the structure of financial sector remuneration. The speaker also stressed that transparency needs to be increased across the different categories of intermediaries, including through integrated reporting by companies, investment banks, stock exchanges, asset managers, investment consultants and asset owners. Mr. Waygood also called for measures to enhance financial literacy, and for all Governments to develop national capital raising plans detailing how they intend to finance the SDGs. These plans could be coordinated at the international level by the UN and the World Bank.

Mr. Magnus Eriksson emphasized that long-term investors, such as AP4, are better placed to take sustainability into account. Mr. Erikkson cited climate change as a long-term threat to the environment and economy, which served to undermine pension funds' returns. He pointed out that AP4 has initiated a CO2 project, through which it has developed and invested in a low carbon strategy with a long investment horizon. As part of this strategy it evaluates stocks of S&P500 companies by their carbon footprint and, based on this criteria, has excluded 100 companies. He emphasized that the performance of its low carbon fund has been very positive and that it has earned excess returns since its inception. Although the reason for the out-performance is unclear, Mr. Eriksson suggested that it might be due to better management more generally in firms with low carbon footprints. He urged other investors to adopt similar low carbon investment strategies. A number of salient points were raised in the interactive discussion, including the following:

- It was suggested that the panel highlighted the potential for change in behavior of private sector investors, as well as the challenges in doing so, particularly on a large scale, without supportive government policies.

- The question of what measures can ensure that private investment contributes better to sustainable development was raised. One issue cited was the better integration of ESG issues into companies' reporting and decision-making processes. In addition, it was pointed out that the incentives favoring short-term time horizons by businesses and investors need to be altered. This can be achieved through, among other things, pricing and performance criteria throughout the investment chain. For example, the remuneration committees of stock exchanges could consider how well they have done in incentivizing sustainable behavior.

- There were also calls for an accountability framework that monitors the impact of FDI on marginalized groups and for ways of incorporating human rights into the investment considerations of foreign investors. At the same time, given that the private finance often does not serve to further development, the importance of having adequate and effective ODA flows to developing countries was asserted.

- There was discussion of the particular challenges faced by LDCs, with questions raised regarding ways to attract sustainable investments to these countries. It was argued that ESG-focused investment could be appropriate for LDCs and that appropriate engagement of all stakeholders at the local level would be critical to ensure that proper benefits accrue.

- Reference was made to the framework on business and human rights proposed by former UN Special Representative John Ruggie ("Protect, Respect and Remedy) which rests on three pillars. These are the state duty to protect against human rights abuses by third parties, including business; the corporate responsibility to respect human rights; and greater access by victims to effective remedy, both judicial and non-judicial. The UN Human Rights Council unanimously approved the framework in 2008. It was proposed that public performance benchmarks should report publicly on how well they are doing on the Ruggie framework and that such rankings should be public.

<u>Conclusion</u>

The co-facilitators of the preparatory process for the Third International Conference on Financing for Development thanked all the participants for the rich array of analysis and viewpoints that were conveyed during the thematic sessions. These would be duly noted and statements posted on the Financing for Development Office's website. The co-facilitators looked forward to a similarly engaging set of discussions during the forthcoming substantive informal sessions due to take place on 9-12 December 2014.

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