

De-risking Development Finance

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Article DOI: [10.48028/iiprds/ijdashmss.v13.i1.08](https://doi.org/10.48028/iiprds/ijdashmss.v13.i1.08)

A b s t r a c t

The world is on a collision course with history and nature in multiple arenas – climate change; reversal in progress against poverty from COVID (costing developing countries 5% of GNP)¹ and 100 million people displaced; half of low-income countries facing debt distress; and manmade conflicts, most notably the unconscionable Russian invasion of Ukraine. This paper explores the solutions to these challenges.

Keywords: *De-risking, Development, Finance*

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First Published: <https://www.brookings.edu/testimonies/de-risking-development-finance/>

Background to the Study

Context – The Imperative to Ramp up Development Finance

1. \$1 trillion/year by 2030 in external finance estimated to meet the needs of climate change and development for emerging market and developing countries.²
2. \$2.5 trillion/year estimated as the (pre-COVID) finance gap for the Sustainable Development Goals, with only \$52 billion provided in 2020.³
3. \$200 billion committed by the U.S. to the \$600 billion G-7 Partnership for Global Infrastructure and Investment
4. (PGII) to finance infrastructure investment for low- and middle-income countries by 2027.
5. \$100 billion/year in climate finance by 2020, a commitment made at the 2009 Copenhagen COP, reached only \$83 billion in 2020 and will not meet the target level until 2023.⁴
6. Put those financing needs in the context of current levels of development finance and the financial precipice confronting developing countries:
7. Private finance – \$63.6 billion in private finance was mobilized by MDBs/DFIs in 2019 for middle- and low-income countries.⁵ “If, as is necessary, the flows of finance from the MDB and DFI systems are to be multiplied by three within five years (\$60 billion to \$180 billion), then decisions must be taken very rapidly.”⁶
8. Credit – During 2020/21, 44 developing countries had their credit downgraded by at least one of the three major ratings agencies and 28 had their outlook downgraded.⁷
9. Debt – “One-third of all developing countries and two-thirds of low-income countries are at high risk of debt distress. ... Credit rating agencies have been systematically lowering their assessments of sovereign creditworthiness since the onset of the pandemic.”⁸

Reports and statements on development finance demonstrate a growing consensus around the urgent need to dramatically ratchet up development finance, that private finance has a significant role to play, and that heightened DFI risk appetite and de-risking instruments are among the solutions:

- a. Finance for Climate Action: Scaling Up Investment for Climate and Development (November 2022; 25 international finance/development experts).
- b. Boosting MDBs’ investing capacity: An Independent Review of Multilateral Development
- c. Bank’s Capital Adequacy Frameworks (2022; referred to as the “G-20 Capital Adequacy Review”; by 14 international finance/development experts).

¹ Gerszon Mahler et al 2021

² *Finance for Climate Action: Scaling Up Investment for Climate and Development; Report of the Independent High- Level Expert Group on Climate Finance, November 2022*

³ OECD, *Making Private Finance Work for the SDGs, July 2022*

⁴ Kharas and Rivard, *The yawning gap between SDG attainment and international development finance, September 2022*

⁵ *Mobilization of Private Finance; MDB Task Force on Mobilization, 2019*

⁶ *Finance for Climate Action*

⁷ Kharas and Rivard

⁸ *Finance for Climate Action, page 35*

- d. Bridgetown Agenda endorses the G-20 Capital Adequacy Frameworks Review and increased risk appetite to expand development finance (September 2022).
- e. Reforming the World Bank and Multilateral Development Banks to Meet Shared Global Challenges (October 2022; 17 international finance/development experts).

Secretary Janet Yellen, in an October 6, 2022, address at the Center for Global

Development, called for an evolution in the business practices of multilateral development banks to better meet global development finance needs. She noted “information asymmetry” and “a shortage of tools to diversify risks beyond individual projects with uncertain returns.” How is it that private finance is seen as part of the solution? First, entrepreneurs and businesspeople understand the market, are a source of innovation, and tolerate a degree of risk. Second, collectively, pension funds⁹, insurance companies, and investment funds hold an estimated \$100 trillion¹⁰, mostly in low-return investments. The question is how to unlock even a small percentage of those funds for investment in low- and middle- income countries.

De-risking Development Finance

Risk plays a role in how DFIs can help meet the financial needs of developing countries and mobilize private finance in two ways. One is country focus – enhancing the risk appetite for participating in financing projects in poor and fragile nations. The second is project de-risking, through using one or more de-risking instruments.

Like many DFIs and its predecessor OPIC, the DFC has a low tolerance for risk. DFIs lean toward measuring success in number of deals and impact. Those are fine objectives, especially impact on development, but the BUILD Act and the times require more – taking greater risk by giving priority to low- and lower middle-income countries and to mobilization of private finance by reducing/sharing/managing the risk.

There are a number of instruments for de-risking; risk mitigation, risk sharing, and risk transfer. A list is presented in the appendix. Four deserve elaboration – concessional and blended finance are readily available but infrequently deployed; collaboration can mobilize additional finance and broaden risk sharing; transparency can be a powerful tool for de-risking.

- a. Concessional finance: Concessional finance involves pricing a project at below market rates, either through a low interest rate, loan tenor, or grace period. For projects that are assessed to have market potential but for which the risk is higher than the market can bear or too far in the future, concessional finance can facilitate a project moving ahead. It is most appropriate at the early stage of a project when the risk is outside the appetite of private investors. The DFC can support pre-feasibility and feasibility studies and initial proof-of-concept investment. DFC finance can help a start-up prove its commercial viability; launch an economic activity with marginal profitability but high social/economic impact (e.g., a plant for processing milk from

⁹ 300 largest pension funds had assets under management in 2021 of over \$23.6 trillion. WTW Investments. September 6, 2022 press release.

¹⁰ Mobilization of Private Finance; MDB Task Force on Mobilization, 2019. Page 35

hundreds of local dairy farmers); cover low financial returns in the early phase of a new enterprise; support investment in riskier markets such as decarbonization.

- b. **Blended finance:** Blended finance involves combining a market-rate loan with grant assistance. It can be deployed by the DFC acting alone or in conjunction with USAID, MCC, State Department, USTDA, and philanthropic organizations. OPIC had limited success in garnering grant funds from USAID and State Department, but the DFC now has its own modest level of funding for technical assistance. Joining DFC's knowledge of finance and the marketplace with USAID and other agencies' experience in how to deploy technical assistance could be a powerful tool in reducing market risk.
- c. **Collaboration:** With collaboration, DFIs can mobilize additional finance through better management/sharing of risk and taking advantage of each organization's strength. They can share due diligence, market information, and deal pipelines. Currently, if several DFIs decide to jointly finance a project, each has to execute its own due diligence, typically ad seriatim, extending the time to package the finance from months to a year or more; how much better if the due diligence of the originating DFI could be accepted by other DFIs. Further, through operating together and joining their voices, they can be more effective in influencing partner government policies. Ultimately, were DFIs to standardize due diligence processes, project documentation, and project terms, and collaborate through established platforms, collaborative project origination would be facilitated, particularly important for large infrastructure projects.¹¹
- d. **Transparency:** The role of data transparency as a de-risking tool was a principal topic at the October 14 Brookings roundtable. Its role is not well understood. The underlying premise is that investors need information in order to understand market risk and opportunity.¹² With the movement to private finance should be put into a common anonymized database housed in an independent entity and available to financiers.
- e. **Project/impact data:** Publish What You Fund is near completion of a two-year research project on transparency of development finance. In January 2023 it will release the first Development Finance Transparency Index. Based on 47 indicators, the Index will report the extent to which 30 DFI portfolios make data on their investment projects public. The DFC has been an active, constructive participant in the project and can build on the assessment in the Index to position itself as a DFI leader in transparency.

Dramatically ramp up development finance, transparency is essential to ensure it is well deployed and to move from assumed to actual market risks. As noted in a recent OECD report,

¹¹ Neil Gregory, *Taking Stock of MDG and DFI Innovations for Mobilizing Private Capital for Development*; forthcoming

¹² *Mobilization of Private Finance*, page 37

“lack of credible information or transparency dissuades new market participants as the risks and opportunities of investing in frontier markets remain unclear.”¹³ Another OECD report explains that “MDBs and DFIs can leverage their high-quality loan portfolios which are characterized by strong underwriting capacities, long track record, low default rates and their preferred creditor status”.¹⁴ The de-risking role of making data available is best understood by a real-world anecdote. Moody's publication of data on the probability of default and recovery rate on infrastructure investment in developing countries revealed that the risk was less than perceived and thereby expanded access to the sector for infrastructure debt investors.¹⁵

- f. Risk/default data: Multiple reports on mobilizing development finance articulate the value of data transparency. A recommendation in the G-20 Capacity Review Report, as in earlier reports, is to make available the data on GEMS – the Global Emerging Markets Risk Database Consortium, developed by DFIs and MDFIs. GEMS is a database of statistics on risks of investing in developing countries, including historical default rates, recovery rates, and losses.¹⁶ Several participants at the October 14 Brookings roundtable went further in suggesting that data from DFIs and private finance should be put into a common anonymized database housed in an independent entity and available to financiers.
- g. Project/impact data: Publish What You Fund is near completion of a two-year research project on transparency of development finance. In January 2023 it will release the first Development Finance Transparency Index. Based on 47 indicators, the Index will report the extent to which 30 DFI portfolios make data on their investment projects public. The DFC has been an active, constructive participant in the project and can build on the assessment in the Index to position itself as a DFI leader in transparency.

Governance and Management

Instrumentalizing greater appetite for risk involves clear signals in governance and management on the governance side, from the Congress and the board, and on the management side, from senior executives – that reasonable risk is not just acceptable but expected. The Congress in the BUILD Act expressly sets priority for risky environments, low-income and fragile states and in advancing development, not profits. Colleagues in civil society organizations committed to the success of the DFC, and I, will be working to bring to the attention of the four congressional committees of jurisdiction the imperative for the DFC to heighten its appetite for risk and use of de-risking tools including explaining that with heightened risk comes some loss.

The board needs to make clear the same determination that prudent risk taking is expected and that it will have the DFC's back in explaining that with heightened risk comes greater impact but also loss. Management, starting with the CEO, needs to incentivize greater risk tolerance

¹³ OECD, *Making Private Finance Work for the SDGs*, July 2022

¹⁴ *Making Blended Finance Work for Sustainable Development: The Role of Risk Transfer Mechanisms*

¹⁵ Thanks for Nadia Nikolova and Letitia Ferreras Astorqui of AllianzGI for this anecdote.

¹⁶ OECD, *Making Private Finance Work for the SDGs*, July 2022

and use of de-risking tools. It is the board and senior management that set the tone and strategic direction of an organization, and in the case of the DFC this requires the CEO leading change management – change in the culture/perception/acceptance of tolerating and managing risk.

Conclusion

It is the United States that is best positioned to provide the leadership the world needs to ramp up the finance required to deal with climate change, bring nations and communities closer to achieving the 2030 Global Goals, implement the G-7 commitment to the Partnership for Global Infrastructure and Investment, and build back Ukraine. This U.S. leadership requires the collective effort of all U.S. government agencies engaged in development. The DFC can help mobilize that leadership through demonstrating how greater risk appetite and use of de-risking tools can significantly mobilize development finance for low- and lower middle-income countries and achieve greater impact.

Appendix – Instruments for de-risking private finance

- A) Funded risk transfer/sharing
- a. Concessional finance
 - b. Blended finance
 - c. Grants
 - d. First loss structures in pooled vehicles to reduce risk for private investors
 - e. Subordinate and “venture” debt, mezzanine finance, equity
- B) Unfunded risk mitigation
- a. Guarantees – greater use of the Development Credit Authority to expand the scope and risk appetite of local financial institutions.
 - b. Insurance – ADB used \$921 million of credit insurance in 2019, of which \$514.3 million was in local currency¹⁷.
 - c. Credit sharing and transfer – such as securitization (AfDB's Room2Run) and collaborative financing platforms (co-lending syndications - IFC's Managed Co-Lending Portfolio Program)¹⁸.
 - d. Local currency lending and hedging – debt indexed in local currency so the risk is born by the DFI/MDB – 90% of debt in low-income countries is denominated in SDRs and dollars.
 - e. Transparency of data to allow more realistic assessment of market risk and impact.
 - f. Sharing return/default data with credit agencies so their risk assessment is accurate.
 - g. Standardization of due diligence and project documentation and terms.
 - h. Dialogue – greater dialogue and collaboration among DFIs and between DFIs and the private sector at the levels of institutions, transactions, and sub-transaction; DFIs should listen to the private sector as to what it needs for participation in an investment.

¹⁷ *Mobilization of Private Finance. Multilateral Development Banks and Development Finance Institutions. 2019. Page 34*

¹⁸ *OECD, Making Blended Finance Work for Sustainable Development: The Role of Risk Transfer Mechanisms, September 2021*

Reference

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