Paper regarding the creation of an

Australian Development Finance Institution

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Introduction and Summary

Concept

That Australia considers creating a sovereign Development Finance Institution ("DFI") in order to engage in the growing market for impact investing that is revolutionizing overseas aid.

Discussion

Australia's total contribution to Overseas Development Assistance (ODA) or foreign aid in 2016-17 was A$3.8 billion (USD 3 billion) or approximately 0.25 per cent of GNI. This was below the average of 0.32 per cent of GNI recorded by the 29 OECD countries last year and Australia is now ranked 17th among them[1]. This is a far cry from prior government commitments to increase Australia's foreign aid budget to 0.5 per cent of GNI (which at the time would have doubled the aid budget from A$4.3 billion in 2011 to nearly A$8 billion by now).

In this situation, it is paramount that the foreign aid budget is deployed with maximum effectiveness and efficiency, and that is the main driver behind the idea of creating a DFI to augment future aid activities.

Among other major country donors it is common to supplement grant-making and capacity building activities with one or more social investment vehicles. This is the case even where they hold active roles in multi-lateral development banks or funds.

These countries (see sample list below) have concluded that strategic investment for specifically targeted social outcomes is an effective and efficient approach to complementing and enhancing their humanitarian aid activities. Such investment acts on different levers within the recipient country's economy, seeking to leverage its impact by stimulating market forces to release dormant or under-utilised resources already present to maximize the effect of the invested funds.

The best social investment catalyses sustainable economic activity or infrastructure sufficient to repay the invested funds over time, as well as to continue to generate a surplus going forward. Thus the impact remains and grows well beyond the direct period of donor intervention. Investing (versus grant-making) preserves the donor country's capital, enabling it to be recycled for multiple uses over time. This is a unique benefit over pure aid.

This approach, known as impact investing, is well-proven, and most OECD countries have opted to use structures such as development banks, DFIs or investment funds to deliver desired outcomes.

[1] http://www.oecd.org/dac/development-aid-rises-again-in-2016-but-flows-to-poorest-countries-dip.htm

What is Impact Investing?

Recent Trend

In recent years there has been a global trend of moving development policy towards increasing commercial investment and leveraging private capital flows to supplement development assistance. Microfinance – pioneered by groups such as Opportunity International (founded by former Senior Australian of the Year, David Bussau) and Grameen Bank (founded by 2006 Nobel Peace Prize winner, Mohammad Yunus) - is one of the early examples. Other sectors that have expanded in this way include housing, health care, renewable energy, water/sanitation, physical infrastructure and rural development.

These types of investments to promote development and their funds have many names, such as triple-bottom-line, venture philanthropy and social-impact investing. However, each form of "impact investment" has the common goal of achieving a development result as well as a financial return.

Impact investors operate in the space between ODA and commercial investment. They are seeking to address problems through market-based, for-profit models that provide both a social benefit and the positive financial return necessary to generate a self-sustaining revenue stream and achieve scale.

Growth in Impact Investment

Some of the countries in which such an approach has been successful include Taiwan, South Korea, China and many parts of Eastern Europe. Whilst most of these markets can now access mainstream foreign direct investment – in no small part due to the leads taken by impact investors – it is now the more challenging emerging markets of poorer Asian countries, the Pacific and Africa that are the frontier markets for such funds.

The growth of impact investment can be best gauged by the numbers of vehicles. One way to gauge the size of the market is through the Global Impact Investing Network (GIIN) Annual Impact Investor Survey[2] that, in 2017, was based on an analysis of the activities of 209 of the world's leading impact investing organizations, including fund managers, foundations, banks, DFIs, family offices, pension funds and insurance companies. GIIN Survey respondents collectively managed nearly USD 114 billion in impact assets, a figure which serves as the best-available "floor" for the size of the impact investing market.

Estimates for future market growth range between USD 450 billion and 650 billion over the next 5 years. Whilst still a small amount compared to total global managed assets of approximately USD 70 trillion, it would be a significant increase in resources targeted directly toward social causes. It would certainly be massive compared to current global ODA, being around four times the amount of USD 142.6 billion in 2016.

[2] Available at https://thegiin.org/knowledge/publication/annualsurvey2017

Such social enterprises have a key need for funding, particularly at the early stages when traditional forms of debt will not be available as cash flows are insufficient to service loans. Moreover, whilst such enterprises will seek commercial returns, they will be less than the levels demanded by traditional venture capital.

Returns from Social Investment

It is rather early in most sectors for reliable data to be available. However, microfinance is one sector with a reasonable history of investment and there are now an estimated 127 Microfinance Investment Vehicles (MIVs) managing funds of USD 13.5 billion.[3] Leaving aside the spectacular returns made by certain investors in some Microfinance Institutions, such as Compartamos (Mexico) and SKS (India), the latest annual returns achieved by MIVs range from 2.6% (equity) to 4.5% (weighted for debt and equity).[4]

Many of the MIVs obtained their initial capital from DFIs, including OPIC (US), DEG (Germany), FMO (Netherlands) and Proparco (France), and others are funded by multilateral institutions such as the Asian Development Bank and the IFC (part of the World Bank group).

Who is Involved

Development Finance Institutions

Virtually every OECD country has established a DFI and/or sovereign development fund. In addition to those already mentioned, other countries with DFIs include the UK, Switzerland, Belgium, Denmark, Finland, Norway, Austria, Italy, Portugal and Spain: see Appendix I for examples.

The British Government has long been active in the field, through CDC (previously called the Commonwealth Development Corporation). This year, the UK Government released CDC's new 5 year strategy[5]. CDC now has a total portfolio of Stg4.8 billion, up from a value of Stg2.0bn just 10 years ago. It provides debt, equity and other support to businesses and investment funds.

As the CDC strategy says: "Like other DFIs, we aim to increase capital flows to underdeveloped markets so countries can finance their own way out of poverty. DFIs focus on less developed or fragile markets and on sectors most important for economic growth. This focus means DFIs typically take more risks." Despite this, CDC has realised an average return of 7.0% over 2012-2016.

Part of the reason for this is that DFIs are specialist investors, skilled at assessing and mitigating developing country risks. Such specialised skills have become less evident in Australia after the merger of AusAID into DFAT in 2013 and a DFI could provide such a permanent institution in which to build expertise in the area of private sector development and foreign aid generally. Moreover, it would allow Australia to move its aid program away from grants only to other instruments, such as debt, equity and guarantees.

[3] Symbiotics, *2017 MIV Survey*, September 2017

[4] Ibid.

[5] CDC, *Investing to transform lives: Strategic framework 2017–2021*, available at www.cdcgroup.com

Thirdly, DFIs aim to invest in a commercially sustainable manner in the private sector of developing countries and to attract or catalyse other investors by demonstrating success. For example, in 2016 over Stg700 million of private capital was invested alongside the Stg289 million from CDC.

Impact Achieved

As a result of this approach, over a million jobs were created by CDC portfolio companies in 2015 and another 17.9 million jobs were supported.[6] In addition, it cites the impact on local taxation, with Stg5.9 billion paid by CDC portfolio companies to local governments in 2012-2015.

The German DFI, DEG, highlights[7] the impact of its portfolio on:

- creating and securing about 145,000 jobs;
- producing green energy for around 5 million people; and
- contributing EUR 280 million in taxes annually.

Other project impacts measured by DFIs include:

- current public revenue;
- net currency effects;
- employment;
- technology and know-how transfer;
- extension and improvement of basic service supply;
- improvement of performances thanks to private operators;
- social effects (health, education, continuous training, etc);
- compliance with environmental standards; and
- positive environmental impacts from greenhouse gas mitigation measures, the use of renewable energies and energy saving.

These sorts of significant impact could also be achieved by an Australian DFI.

Conclusion

It is estimated[8] that the Australian impact investing sector alone will be worth A$33 billion by 2022. With clearly established social and financial outcomes, private investment capital devoted to social causes will quickly dwarf aid and other assistance efforts.

Sectors such as finance have been proven to be viable and others, such as clean energy, infrastructure, housing, healthcare and technology (including Fintech), have the potential for commercial returns. Whilst not all will be appropriate for impact investment, there is a real role for the Australian Government to join other OECD countries in becoming involved in the sector, through the creation of its own development finance institution.

[6] Ibid, page B

[7] https://www.deginvest.de/International-financing/DEG/%C3%9Cber-uns/Was-wir-bewirken/

[8] https://theconversation.com/explainer-the-rise-of-social-impact-investing-73357

Appendix I: National Development Finance Institutions

Name	Sponsor Country	Mission / Description	Fund Size / Website
CDC Group (formerly the Commonwealth Development Corporation)	United Kingdom (owned by Department for International Development)	CDC's objective is to invest in a commercially sustainable manner in the poorer countries of the developing world and to attract other investors by demonstrating success. CDC's capital is focused on the private sector as the engine of growth.	Stg4.8b www.cdcgroup.com
Proparco	France (owned by French development agency, AFD)	PROPARCO promotes private investment in emerging and developing countries with the aims of supporting growth, sustainable development and the Sustainable Development Goals (SDGs). Projects include infrastructure (eg roads, telcos, energy), financial inclusion and climate change.	Eu5.4b www.proparco.fr
Swiss Investment Fund for Emerging Markets (SIFEM)	Switzerland (State Secretariat for Economic Affairs and other public and private investors)	SIFEM promotes long-term, sustainable and broad-based economic growth in developing and emerging countries by providing financial support to commercially viable small and medium-sized companies (SMEs) as well as fast-growing enterprises which in turn helps to create secure and permanent jobs and reduce poverty.	US$793m www.sifem.ch
Development Bank of Southern Africa	South Africa (and SADC)	To advance the development impact in the region by expanding access to development finance and effectively integrating and implementing sustainable development solutions to: improve the quality of life of people through the development of social infrastructure; support economic growth through the investment in economic infrastructure; support regional integration; and promote sustainable use of scarce resources	R79b www.dbsa.org
KfW Banken Gruppe	Germany	Climate change, education, energy, FIs, health	Eu507b (assets) www.kfw-entwicklungsbank.de

Name	Sponsor Country	Mission / Description	Fund Size / Website
DEG	Member of KfW group	Finance investments by private sector in emerging economies	Eu8.6b www.deginvest.org
Belgium Investment Company for Developing Countries (BIO)	Belgium	Support a strong private sector in developing and/or emerging countries, to enable them to gain access to growth and sustainable development within the framework of the SDGs, by funding businesses and SMEs, also infrastructure and funds, eg RE	Eu463m www.bio-invest.be
Netherlands Development Finance Corporation (FMO)	Netherlands (51% by the Dutch State and 49% held by commercial banks, trade unions and other members of the private sector)	Entrepreneurial development bank, providing capital and advice to promote the private sector, eg infrastructure, housing, energy, FIs, food	Eu9.0b www.fmo.nl
OPIC	USA	Helps American businesses invest in emerging markets, by providing businesses with the tools to manage the risks associated with foreign direct investment, fostering economic development in emerging market countries, and advancing U.S. foreign policy and national security priorities	US$200bn[9] www.opic.gov
Finland Fund for Industrial Cooperation (FinnFund)	Finland (State of Finland 93.8%, Finnvera 6.1% and Confederation of Finnish Industries EK 0.1%)	Promotes sustainable development by providing long-term risk capital for private projects in developing countries. Investment criteria include profitability, sustainability and positive development impacts in the target country.	Eu$329m www.finnfund.fi

[9] Invested since OPIC established.