A Development Finance Institution for Australia's Aid Program

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Recommendation

It is proposed that Australia creates a sovereign Development Finance Institution (DFI) to engage in the growing market for "impact" or "social" investing that is revolutionising overseas aid.

Context

Funding for development assistance globally has grown significantly in the last two decades. Yet, financing gaps have become increasingly apparent within the context of the United Nations (UN) 2030 Agenda for Sustainable Development and the accompanying Sustainable Development Goals (SDGs), with estimates ranging from US$500 billion to several trillion in *additional* financing needed each year to reach the goals. In 2018, total Official Development Assistance (ODA) from all OECD DAC member countries totalled US$153 billion, an increase of only US$10 billion in two years. Even if all OECD countries were to meet the 0.7% of Gross National Income (GNI) target, total ODA would not likely exceed US$400 billion per year.

Hence, ODA and traditional forms of grant and concessional finance remain important but have been recognised as insufficient.

A DFI can make loans, take equity and/or provide guarantees to support private investments promoting development. In this age of financial constraint, it will also allow the Government to fund other initiatives proposed in the current review of Australia's aid program. There is a growing track record of projects where commercial investors are involved in addition to DFIs, in particular in infrastructure and climate finance projects.

The use of commercial funds for development is not as new as some proponents of impact investing would contend. Bankers have been involved in aid for many decades, notably through microfinance, pioneered by groups such as Opportunity International (started by former Senior Australian of the Year, David Bussau) and Grameen Bank (founded by 2006 Nobel Peace Prize winner, Mohammad Yunus).

It was the first successful impact investment area. An early example is the Mexican microfinance institution Compartamos: one initial investor realised a staggering 134 times its US$1 million investment, over a period when Compartamos grew to reach 660,000 clients, 98% of whom were poor women.

Early European DFIs mostly focused on ODA. Now globally DFIs' portfolios have changed, and various new players have entered the industry, for example, FinDev in Canada (established in 2018) as well as emerging market institutions like China Development Bank (CDB).

Rationale

There are at least **five reasons** why Australia should establish a DFI.

First, it makes financial sense.

Australia's aid budget is much smaller than it was - and even less than once forecast. Our ODA has fallen from A$4.3 billion in 2011-12, which represented 0.36 per cent of GNI, to A$4.0 billion or approximately 0.21 per cent of GNI. So, it is important to do things more efficiently and effectively.

The UK's DFI, CDC, has obtained a seven per cent annual return whilst building its capital base to £4.8 billion, from a value of £2.0 billion just ten years ago. It has not had to draw on public funds in over 15 years. The funds invested by CDC catalysed other investors, together driving economic growth. An example of this is the creation of a million jobs by CDC portfolio companies in 2015 while another 17.9 million jobs were supported.

The United States Overseas Private Investment Corporation, OPIC, estimates that it earns $8 for U.S. taxpayers for every $1 invested in its overhead.

Using impact investment as part of the aid program would also be consistent with the Foreign Policy White Paper released in 2017, with one of the four tests it set for Australia's aid program being to "deliver results and value for money".

If Australia achieved the sort of returns that the UK has from its DFI (7% on £4.8 billion), that would add some A$500 million to our aid budget - in sustainable annual income. That would represent a boost of one-eighth to the current aid budget, from which many exciting aid initiatives could be funded.

Second, its potential for impact far exceeds traditional grant and concessional programs.
Donors are putting less money into aid and grants anyway, and more into impact investments, in areas such as Fintech, renewable energy, infrastructure, healthcare and education. Estimates for future market growth in impact investment range between US$450 billion and US$650 billion over the next 5 years. This would represent around four times the global ODA of US$153 billion in 2018.

DFIs generally operate according to three core principles: additionality; catalyzing investments from other investors; and promotion of sustainable economic development. DFIs often act as first movers and initial risktakers through piloting and investment testing in specific industry sectors.

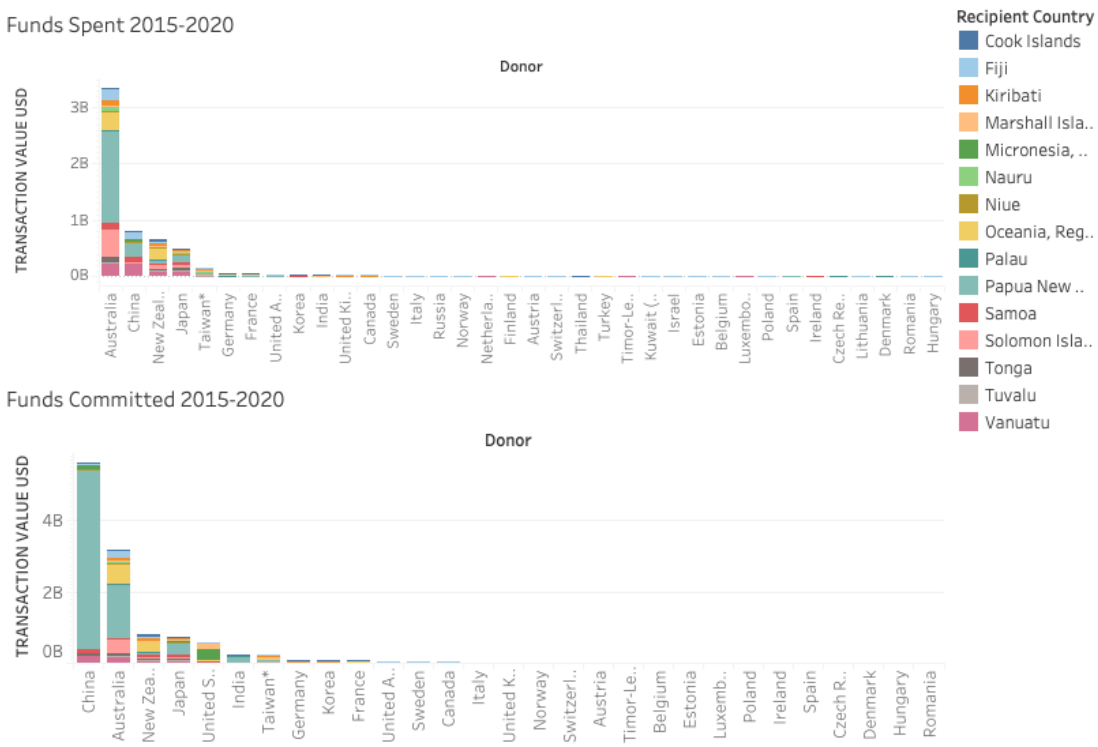
"Additionality" is a key element of the DFI concept. It is the goal of enabling an investment which would not otherwise happen. The Netherland's DFI, FMO, defines financial additionality as: "providing financial services only where the market cannot or does not do the same, or otherwise does not provide on an adequate scale or on reasonable terms" (FMO, 2019). Their ultimate rationale is to address market and coordination failures in capital markets. They fill investment gaps.

Moreover, DFIs aim to "crowd-in" other sources of finance. In evidence provided for Canada's creation of a DFI it was found every $1 invested by a DFI has the potential to catalyze an additional $12 in private investment. This concept of "catalytic finance" revolves around the idea that providing government assistance to a country, a company or a specific transaction, encourages other and, in particular, private actors to engage as well. Private sector development is key for creating jobs, increasing public revenues through tax payments, and generating growth. Government financing vehicles— such as an AuDFI— can be a "gatekeeper" unlocking or opening the door to private capital and other financial flows.

Third, it allows Australia to keep up with its peers.
Most OECD countries, including the US, Canada, the UK, Germany and France, have a DFI. However, none focuses on the Indo Pacific region, where Australia's ODA is now concentrated.

Australian ODA to the Pacific over the last 5 years ranks far higher than other donor countries and multilaterals in terms of spending. However, in terms of commitments, China's investments are much high by far and nearly double Australia's. See figure 1. Additionally, the rate of growth in Chinese investment and the speed with which new Chinese financing vehicles have been established in recent years has been substantial.

Figure 1: Pacific ODA Commitments and Spending



Source: Diagrams developed for this based on data from https://pacificaidmap.lowyinstitute.org

Besides traditional grants and concessional loans, China's DFI provides equity and investments through its subsidiary CDB Capital Co. Reportedly, in 2017 CDB Capital Co. made new investments worth approximately €7.9 billion globally. Furthermore, CDB manages specific impact funds including the China-Africa Development Fund, the first Chinese investment fund dedicated to spurring investments of Chinese enterprises in Africa. In 2017 this Fund had some US$4.6 billion under management. By the end of 2018, CDB's total assets grew to RMB 16.2 trillion and yielded a net profit of RMB 112.1 billion.

Most DFIs are set-up as independent government-owned financial institutions applying private-sector management principles. DEG operates as a non-profit limited company and a legally independent, wholly owned subsidiary of the German Development Bank, KfW, and FMO (the Netherlands DFI) is set-up as a public-private partnership with the Dutch government and private investors, including several commercial banks and other shareholders. There are also examples where DFIs are subsidiaries of national Export Credit Agencies, namely FinDev (Canada) and SIMEST (Italy). Figure 2 provides an overview of key data on several OECD DFIs.

Figure 2: Selection of DFI Key Figures (2018)[1]

DFI	Total net assets (AUD, 2018)	New Commitments (AUD, 2018)	Profit after tax (AUD, 2018)	Subscribed capital (AUD, 2018)	Mandates / Thematic Focus	Categories of Regional Focus	Employees
Proparco (France)	8.8 m	0.4 m	43,898	1.2 m	Private sector contribution to SDGs	Asia; Latin America; Caribbean; Africa; Eastern Europe & Central Asia	220+
DEG (Germany)	9.5 b	3.0 m	105.7 m	1219.4 m	Private sector promotion	Asia; Latin America; Caribbean; Sub-Saharan Africa; Caucasus;	601 (2017)
FMO (Netherlands)	13.81 m	3.1 m	245,505	73,781 *authorised	Private sector development; energy; infrastructure; food & water	Asia; Latin America; Caribbean; Africa; Eastern Europe & Central Asia	444 (2017)
CDC (UK)	10.5 b	1.92 b	10.87 b	1343.8 b	Poverty alleviation, private sector development, low carbon and ESG, developing capital markets	Africa; South Asia	492
OPIC[2] (USA)	13.7 b	4.7 b	8.2 b	41.2 b *investment cap	Foster economic development and advance US foreign policy	Asia & Pacific; Latin America & Caribbean; Middle East & North Africa; Europe & Eurasia	271
FinDev (Canada)[3]	101,000	31.2 m	(9,000)	312 m (over 3 years)	Climate Mitigation and adaption; women's empowerment; infrastructure	Sub-Sahara Africa; Latin America and Caribbean	20
CDB (China) (2018)	3.3 tr	—	23.1 b	6.68 b	Enhancing national competitiveness and improving people's livelihood	China; outside of mainland China	9147
Cofides (Spain)	222 m	499.9 m	14,944	64 m	Contribute to the SDGs and promote the internationalization Spanish companies	Asia; Latin America; Caribbean; Africa; Eastern Europe & Central Asia	93

[1] Data gathered from annual reports.

[2] A 2018 Act consolidates the Development Credit Authority (DCA) of the US Agency for International Development (USAID) and the Overseas Private Investment Corporation (OPIC) into a reformed U.S. International Development Finance Corporation (USIDFC).

[3] 2018 is the inaugural year.

Fourth, it gives Australia a wider toolkit for humanitarian aid.

DFAT is already allocating some aid into projects such as the Emerging Markets Impact Investment Fund. However, this is being done through grants only to an independently managed vehicle. A DFI would place Australia 'behind the wheel' of this new form of development assistance. It would also allow Australia to transition its aid program away from grants and towards other instruments such as debt or equity and guarantees, already part of many countries' ODA.

DFIs have diverse product offerings including equity, mezzanine financing and direct lending as well as insurance and guarantees. Loans[4] typically occupy a substantial component of DFIs' portfolios. Equity instruments (provided directly or indirectly via dedicated funds) also play an important role. For example, equity investments represent between one third (FMO) and almost half (DEG) of the respective total portfolios. Finally, guarantees are often a key element in a DFI's toolkit. FMO's guarantee portfolio amounted to more than €200 million in 2017, while other DFIs, such as Austria's OeEB, France's Proparco and the UK's CDC, have bigger guarantee portfolios (CDC has the most substantial guarantee portfolio amongst European bilateral DFIs.)

Collaboration or blending of types of support between DFIs and Export Credit Agencies (ECAs) as well as Multilateral Development Banks (MDBs) is growing, for instance in the form of co-finance and/or in order to support large energy or infrastructure projects in difficult markets where there has been a retreat of commercial banks. China (and some other Asian countries) also use DFIs and ECAs[5] together actively to provide complementary roles and strengthen their overall product toolkit.

Finally, it provides a permanent sustainable institution in which to build expertise.

An Australian DFI could provide a permanent institution in which to build expertise in the area of private sector development and foreign aid generally. Moreover, the cost of running this institution could be funded by the returns generated on its investments.

It would also provide Australia with a permanent vehicle through which it can work alongside international partners and MDBs, thereby reducing duplication of efforts or the likelihood of important large-scale projects failing through from lack of funding.

There is no clear or shared definition or concept of national interest among bilateral DFIs but it is often displayed by support to, or promotion of, national businesses or investors to expand their activities into emerging and developing markets. While the majority of the bilateral DFIs provide financing that is not always contractually tied to procurement from the respective country, almost half of the European bilateral DFIs need to ensure an element of national interest as a prerequisite to provide financing for a project or transaction. Examples include Cofides (Spain), Finnfund (Finland), IFU (Denmark), SIMEST (Italy), SOFID (Portugal) and SBI (Belgium).

Summary

An Australian DFI would create an opportunity for Australia to scale-up its overseas humanitarian impact without substantial redirection or additions to the aid budget. It represents a sustainable solution for long-term regional investment. It also provides Australia with a permanent vehicle to build expertise and scale-up its international cooperation in impactful projects.

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[4] Usually either mezzanine loans/subordinated debt and senior debt. While loan offerings often entail a broad range of services including corporate financing, project financing, M&A financing, and for some also foreign currency lending and trade financing.

[5] Australia already has an established Export Credit Agency: EFIC.