

# Harnessing private finance to attain public policy goals?

How governments try to involve the private sector  
in times of austerity and what risks this entails



**PUBLIC**

**PRIVATE**

Julian Müller

# Colophon

## Harnessing private finance to attain public policy goals?

How governments try to involve the private sector in times of austerity and what risks this entails

July 2016

---

**Authors:** Julian Müller

**Layout:** Frans Schupp

**Cover illustration:** Frans Schupp

**ISBN:** 978-94-6207-104-9

---



**ROSA  
LUXEMBURG  
STIFTUNG**  
BÜRO BRUSSEL

Published with financial support of the Rosa-Luxemburg-Stiftung (Brussels Office) with funds from the German Federal Ministry for Economic Cooperation and Development, and with financial support of the Sigrid Rausing Foundation. The content of this publication is the sole responsibility of SOMO.



**Stichting Onderzoek Multinationale Ondernemingen**  
Centre for Research on Multinational Corporations

**Sarphatistraat 30**  
1018 GL Amsterdam  
The Netherlands  
T: +31 (0)20 639 12 91  
F: +31 (0)20 639 13 21  
info@somo.nl  
www.somo.nl

The Centre for Research on Multinational Corporations (SOMO) is an independent, not-for-profit research and network organisation working on social, ecological and economic issues related to sustainable development. Since 1973, the organisation investigates multinational corporations and the consequences of their activities for people and the environment around the world.



# **Harnessing private finance to attain public policy goals?**

**How governments try to involve  
the private sector in times of austerity  
and what risks this entails**

SOMO

**Julian Müller**

Amsterdam, July 2016

## Contents

<b>Summary</b> .....	<b>4</b>
<b>1 Introduction</b> .....	<b>9</b>
<b>2 What does harnessing private finance mean and what is new about it?</b> .....	<b>10</b>
Which policy areas are affected?.....	11
<b>3 What explains this trend?</b> .....	<b>13</b>
Austerity and the increasing gap between fiscal resources and political challenges .....	13
The financial environment: large pools of private savings and low interest rates .....	15
Neoliberal dominance .....	19
<b>4 Instruments and regulatory measures to harness private finance for infrastructure projects</b> .....	<b>21</b>
Project Bonds: A 'first loss' funding instrument for infrastructure in the EU .....	21
The broader context: turning infrastructure into an asset class .....	26
<b>5 'Leveraging', 'blending' and 'catalytic' funding in development assistance</b> .....	<b>27</b>
Climate public-private partnerships in the UK.....	27
<b>6 'Impact Investment': Social Impact Bonds and Development Impact Bonds</b> .....	<b>30</b>
How do Impact Bonds work? .....	30
The market for SIBs and DIBs.....	32
Some problems of the Impact Bond model.....	34
<b>7 The risks of harnessing private finance</b> .....	<b>37</b>
Volatility makes portfolio investment unfit to be a part of sustainable finance .....	37
Pro-cyclicality: increasing exposure to the ups and downs of the economy .....	38
Additionality: who leverages whom?.....	39
Loss of control.....	39
Emergence of a new financing regime?.....	40
<b>8 Conclusions</b> .....	<b>41</b>
<b>9 Recommendations</b> .....	<b>43</b>
For governments and policy-makers .....	43
For activists .....	44

## Acronyms

<b>CP3</b>	Climate Public-Private Partnership
<b>DIB</b>	Development Impact Bond
<b>EIB</b>	European Investment Bank
<b>EU</b>	European Union
<b>FDI</b>	Foreign direct investment
<b>GDP</b>	Gross domestic product
<b>IMF</b>	International Monetary Fund
<b>NGO</b>	Non-governmental organisation
<b>ODA</b>	Official Development Assistance
<b>OECD</b>	Organisation for Economic Co-operation and Development
<b>PPP</b>	Public-private partnership
<b>SIB</b>	Social Impact Bond

## Summary

In recent years there has been a proliferation of policy initiatives that advocate the use of private financial portfolio investment to attain goals that have traditionally been considered the responsibility of government. This affects policy areas as diverse as social policy, macro-economic policy and development assistance. Together these initiatives constitute a more general trend in policy-making that redraws the public/private boundary and implies risks that social movements, civil society and progressive policy makers should be aware of. Low- and medium income countries are particularly affected because they are more exposed to the risks that come with increased reliance on volatile portfolio flows than developed countries, but have fewer capacities for coping with them.

The participation of private business in the delivery of public goods is not new. *Public-private partnerships* (PPPs) also involve a private constructor or service provider as well as a public authority and also tend to involve commercial bank financing. The arrangements examined in this paper are new in that they are not about the construction or provision of a public good, but about how this provision is financed: they aim to attract portfolio investors, in particular pension funds and insurance companies. These investors are not interested in actively controlling companies, but only in financial return. They place a higher priority on the liquidity of their investments and tend to move in and out of them more frequently than banks or FDI.

### Why do policy makers increasingly seek recourse to the private financial sector?

The increasing involvement of private financial investors is often interpreted as ‘financialisation’, i.e. as a series of business-driven attempts to open up new investment spheres. This downplays the role of *political* circumstances and motives, especially attempts by policy makers to cope with, or use, a situation in which deficit reduction and austerity are reducing the fiscal room for manoeuvre.

The monetary resources required to deal with social or environmental problems, as well as the huge development challenges and infrastructure financing needs, currently exceed the budgetary capacities of governments all over the world. The result is a big and widely acknowledged funding gap. At the same time, there is a large and growing pool of private savings managed by private pension funds or insurance companies. Low interest rates render the preferred investments of those funds, risk-free interest-bearing securities, less profitable, creating a funding mismatch between their assets and their obligations to clients. This sends funds on a desperate hunt for more lucrative, but also riskier, assets to finance their long-term obligations. Add to this decades of neoliberal dominance and private sector bias, and the result is a string of attempts to close these two funding mismatches by combining them, i.e. by creating financing arrangements that let private investors pour money into the provision of what used to be government tasks, thereby providing long-term financing for those tasks *and* earning themselves a stable and attractive income to fund their own obligations.

## Some Instruments for harnessing private finance

A full overview of the policy areas and financing arrangements for attracting private investor involvement is beyond the scope of this paper, but it discusses a few of them.

### **Instruments and regulatory measures to harness private finance for infrastructure projects**

Infrastructure financing is currently the most important case of harnessing private finance. Efforts are underway to make infrastructure assets, which are considered relatively risky, acceptable for institutional investors. These efforts are intrinsically connected to promoting the expansion of PPPs for the construction and operation of infrastructure facilities.

EU Project Bonds, launched in 2012, are a specifically designed infrastructure financing instrument. Bonds issued by infrastructure project companies are made less risky, and thus more attractive to investors, because they enjoy 'first loss' guarantees from the EU Commission. The Commission has allocated €230 million from its budget as capital to the European Investment Bank (EIB). On that basis, the EIB provides either subordinate loans or credit guarantees to eligible project companies which then issue senior debt in the form of project bonds to raise more finance. According to the Commission, investment sums of up to 15-20 times the amount of the Commission's contribution could be raised. Apart from 'leveraging' modest public funds, the Project Bonds Initiative also aims to create a win-win situation by creating a financial instrument that matches the need for long-term financing for infrastructure project companies with institutional investors' need for long-term assets.

Civil society organisations have long argued that governments tend to give too many guarantees, subsidies or tax incentives to private actors to entice them into infrastructure PPPs. If, on top of that, private provision of infrastructure is to be financed through complex structures like bonds, another layer of risk and guarantees could be added. *Fiscal risks* will be increased if a government gives guarantees to a project company to ensure that it can meet its payment obligations to bondholders.

In a developing country context, many obstacles would have to be overcome to make such instruments attractive to institutional investors. However, the political will to work to overcome them is clearly there at the level of international organisations. In that case, developing countries will be at higher risk of exposure to volatile cross-border capital flows.

Apart from bonds and credit enhancement there are also regulatory measures to support the establishment of 'infrastructure assets' as an asset class. The EU is using its prudential regulations for investment funds and insurances to boost the uptake of infrastructure-related assets by defining them as a specific asset class that benefits from lower capital requirements. No 'leveraging' of public money takes place here. The purpose is simply to make investing in these assets cheaper and boost investment.

### **'Leveraging', 'blending' and 'catalytic' funding in development assistance**

Development discourse has recently shifted from a focus on public finance to the question of how best to use private-public financing arrangements to mobilise additional resources. 'Leveraging', 'blending' and 'catalytic' funding have become the new buzzwords.

One such initiative is the *Climate Public-Private Partnership* programme, launched in 2012 in the UK. It uses UK government money to foster investment in low-carbon and energy-efficient projects in developing countries and to “demonstrate to private sector investors that climate friendly investments in developing countries are financially viable”. The UK government has injected £110 million into two commercially run private equity funds whose job it is to raise additional money from private and other public sources and to invest that money in low-carbon projects. In this case, public money is not used to reduce the risks for private investors. The goal is to demonstrate to institutional investors that commercially successful investment in climate-friendly projects and technologies is possible in the hope that this will encourage further investment.

The programme has been criticised for its “hands-off approach” and for delegating decision-making to private equity funds who will subordinate ecological and development concerns to commercial considerations.

#### **‘Impact Investment’: Social Impact Bonds and Development Impact Bonds**

SIBs and DIBs are genuinely new instruments that tend to be targeted at investors who are not solely interested in financial return, but would also like to see a ‘social return’. Despite their name, they are not really bonds at all because there is no underlying cash flow and no guaranteed repayment. Instead repayment depends on whether the project financed through their issuance achieves the social or development goals that were specified at the outset. If they are not achieved, investors may only get back their money without a return or even make a loss. In theory, Impact Bonds should transfer financial risks to private investors and generate cost savings for governments.

Impact Bonds have so far remained a largely Anglo-American phenomenon. They are negligible in terms of financial volume and tend to offer unattractive returns. It is very uncertain whether they can become a financing instrument that delivers attractive returns to institutional investors and measurable savings for the public sector. Defining and measuring social or development outcomes and attributing them to a project is very difficult, as is measuring cost savings to governments. Further complexity is introduced by the sheer number of parties involved. Moreover, bond financing only makes economic sense from a certain financial scale upwards. However, social policy and development interventions do not normally require large sums of money. The considerable cost of setting up a SIB/DIB-financed project therefore compares unfavourably with the small sums of money to be raised. It also means that the number of bonds that can be issued in connection with a particular project is too small from an investor’s point of view to make them worth the costs of due diligence.

The danger is that an economically inefficient instrument is made artificially viable by governments by relieving private investors of too many risks. In the longer term, this may even further privatisation of social services.

#### **The risks of harnessing private finance**

Each instrument has unique features and risks, but there are also more general risks that come with harnessing private finance for public policy goals.

- **Volatility makes portfolio investment unfit to be a part of sustainable finance.** Unpredictable 'hot money' flows are not appropriate to finance what are often long-term goals and projects. Developing countries would be particularly exposed because their own capital markets are not deep enough. This would create a number of financial risks for them.
- **Pro-cyclicality: increasing exposure to the ups and downs of the economy.** Portfolio flows reinforce economic trends rather than mitigating them. Relying on them to finance socially and economically important projects exposes the latter to the ups and downs of the economic cycle, whereas public finance is in principle capable of compensating for cyclical funding shortfalls.
- **Additionality: who leverages whom?** Additionality means that the private money in a public-private financing arrangement would not have been invested without the public component. If the private actor would have invested anyway, it is the private sector that is 'leveraging' public money through extracting what is basically an unnecessary subsidy. Additionality is difficult to achieve, and government agencies will have to take great care when selecting and structuring projects to be financed. This further adds to complexity and cost.
- **Loss of control.** Increased private sector involvement can skew decisions about what gets done and what doesn't because political priorities will have to be balanced with commercial considerations. This can lead to policy incoherence, a bias towards certain types of projects, insulation from democratic politics, and the redirection of aid financing away from countries or regions that most need it.

## Conclusions and recommendations

Some of these instruments are relatively recent, but careful consideration of the arguments and existing experiences clearly suggests that, from a public interest perspective, the risks of harnessing private finance to attain public policy goals outweigh the benefits. In the worst case, public-private financing would become a permanent feature of the public policy financing regime. Not, however, as a self-sustaining form of finance, but a highly undesirable compromise between public and private provision in which private sector actors continuously rely on explicit or implicit public subsidies.

Governments should opt for a system of public provision/procurement and development assistance based on ODA. However, if they feel that they must harness private finance they should:

- formulate an exit strategy
- retain as much control over project selection as possible
- include social and environmental safeguards
- guarantee transparency and accountability
- avoid undue risk transfers to the public
- ensure additionality
- avoid Impact Bonds altogether.

Activists and civil society organisations should:

- ▣ campaign for a return to a system of public provision/procurement and development assistance based on ODA
- ▣ make the connection to the demands of the tax justice movement
- ▣ insist on the long-term goal of restoring the fiscal capacity of the state to carry out the necessary investments and interventions by itself
- ▣ emphasise the need for an exit strategy.

# 1 Introduction<sup>1</sup>

In recent years there has been a proliferation of policy initiatives that advocate the use of private financial portfolio investment to attain goals that have traditionally been considered the responsibility of government. This can be seen in policy areas ranging from social policy to macro-economic policy and development assistance. It is not just the policy areas that are diverse. Harnessing private finance is also being promoted by very different institutions and in different parts of the world – from the Organisation for Economic Co-operation and Development (OECD) or United Nations (UN) in the case of financing for infrastructure and development projects, to the European Commission in the case of macro-economic policy, to national governments in the case of ‘Social Impact Bonds’. Together these initiatives constitute a more general policy-making trend that redraws the public/private boundary and creates political and economic risks that social movements, civil society and progressive policy-makers should be aware of.

So-called ‘hot money’ flows are one of these risks. For example, if infrastructure is to be financed or part-financed through an instrument that is bought by portfolio investors, the financing of that infrastructure comes to depend on portfolio investment flows, which are known to be highly unreliable. (See Sections 4 and 7 for more information.) Low- and medium-income countries are particularly at risk. Not only does the trend described in this paper include policy areas that are crucial to achieving development goals, such as infrastructure financing. These countries are also more exposed to the risks that come with the increased reliance on portfolio investment flows than developed countries, such as the notorious volatility of those flows, but are less well-equipped to cope with them.

Previous reports have dealt with individual policy areas in isolation without looking at the connections between them. The aim of this paper is to bring out these connections and demonstrate what the emerging trend means for both developing and developed countries. Focusing specifically on risks is designed to enable civil society and social movements to be more focused and more effective in their critique and recommendations because the language of risk is widely used in public debate and gets policy-makers’ attention more easily. Moreover, putting these developments into their broader political and economic context also helps to counter the exaggerated promises of those who see harnessing private finance as a panacea to the fiscal challenges that governments are confronted with in today’s climate of austerity.

Section 2 explains in more detail what ‘harnessing private finance’ means, what is new about it and which policy areas are affected. Section 3 examines the fiscal, financial and political context to explain why this is happening now. Sections 4 to 6 explain some of the financing instruments and arrangements that are being developed to harness private finance and also discuss some problems that are specific to each of these instruments, Section 7 then sets out the *general* risks of harnessing private finance. Sections 8 and 9 conclude and make recommendations for activists and policy-makers.

---

1 This paper has benefitted tremendously from comments and input from Wiert Wiertsema (Both Ends), Xavier Sol (Counterbalance), Ame Trandem (SOMO), Dexter Whitfield, Maria José Romero (Eurodad), Roos van Os (SOMO), Patricia Miranda (Latindadd) and Matti Kohonen (Christian Aid). None of them can be held responsible for any of the paper’s shortcomings.

## 2 What does harnessing private finance mean and what is new about it?

Sometimes achieving a political goal only requires a change in law or regulation, or a tax on a particular activity. States can decide to ban a practice that is considered undesirable or put a tax on it, as in the case of alcohol and other drugs. They can also encourage desirable behaviour through tax incentives or relaxing regulation. For example, relaxing environmental regulations can be used to stimulate investment in a particular branch of the manufacturing sector. In other cases, however, achieving a particular political goal means that governments have to spend large amounts of public money – either directly, as in the case of social welfare transfers or public infrastructure – or indirectly – for example, when they subsidise industries considered important.

In recent years, however, governments have been less able and/or willing to find the money, whereas the resources required to achieve political goals have in some cases increased. The huge investments needed to combat and adapt to climate change are the most prominent example. In this situation, policy-makers are increasingly looking to private financial investors to fill the gap and to contribute the funds needed to make investments or to finance projects that mitigate a certain problem.

This does not mean that private financial investors take over 100 per cent of the financing of a particular project. Instead there is always some degree of mixture/blending of public funds or public guarantees and private sector funds. This is necessary because the projects or investments in question are usually not interesting for investors whose strategy is to buy low-risk assets with a moderately high yield. These projects are either too risky, not profitable (enough), too long-term, or there might simply not be enough assets to invest in related to a particular project. By contributing public funds or making guarantees, governments make investing in such projects less risky and/or more profitable and thus more attractive to financial investors. To this end a number of financing instruments and arrangements are being created, some of which are described in more detail below.

The term ‘leveraging’ is commonly used to describe this. Just as a long stick can be used to amplify the effect of a small force, the idea is that modest amounts of public funds (or the mere promise to contribute public funds) can be used to attract, or ‘leverage’, far larger amounts of private investment.<sup>2</sup>

So what is new about this? The participation of private for-profit businesses in the delivery of public goods is not new. *Public-private partnerships*, or PPPs, also involve collaboration between a private constructor or service provider and a public authority. They also tend to involve private finance because the joint venture company that is typically created to construct something or to deliver a service is usually also financed by regular commercial bank loans (see section 4).

---

2 The term ‘leverage’ is commonly used in corporate finance. There it refers to the activity of increasing the original capital a company has to work with (its equity capital) by taking on debt capital and using that debt to buy more assets than it otherwise could have purchased and used. Provided that the interest paid on the debt is lower than the profit earned from the additional assets, this will increase the profit rate of the original equity capital.

The arrangements examined in this paper are new and unique in that they are not directly about the construction or provision of a public good, but about how this provision is financed, because the new instruments are designed to attract *portfolio investors*. Unlike foreign direct investment (FDI) or the strategic buying of blocks of shares in a company, portfolio investors are typically passive and do not try to exert control or influence over a company. They are solely interested in the financial return. Moreover, they place a higher priority on the *liquidity* of their investments – the possibility of selling a particular asset again at any given moment. Therefore, they normally move in and out of a particular investment at greater speed than banks or FDI.

There are different types of portfolio investors, such as pension funds, insurance companies and other investment funds that pool and administer the savings of private households. There are also sovereign wealth funds that invest on behalf of states, hedge funds that invest rich people's money, as well as other examples. These investors are commonly referred to as *institutional investors*. It is their participation that the financing instruments examined here are trying to attract. This means that these instruments must give them relatively low-risk financial returns and the option of easy disposability. This creates risks that this paper aims to highlight.

## Which policy areas are affected?

This study takes the view that the trend towards harnessing private finance is more motivated by politics than business agendas. Policy-makers have suggested or applied the idea in various policy areas, including:

- **Infrastructure financing:** Efforts are underway to make infrastructure an asset class that appeals to investors, especially institutional investors as these are deemed to have a long-term investment horizon. These efforts are intrinsically connected to promoting the expansion of PPPs for the construction and operation of infrastructure facilities. European Union (EU) 'project bonds' are an example of a specifically designed financing instrument. They are like regular bonds, only they are guaranteed by the EU budget and the European Investment Bank (EIB). This type of financing for infrastructure development is also being promoted in (or rather to) developing countries (Section 4).
- **Development assistance:** As in infrastructure financing, small amounts of public money are to be used to 'leverage' larger amounts of private finance. However, in this case the public money comes out of official development assistance (ODA). A different, genuinely new, instrument in this field are '*Development Impact Bonds*' (DIBs) (Sections 5 and 6).
- **Environmental policy:** Bond financing ('green bonds') is being promoted to finance, for example, investment in renewable energy facilities. Inasmuch as development assistance is nowadays focused on stimulating 'green growth/development' in recipient countries – as in the case of *Climate Public-Private Partnerships* (CP3) in the UK – environmental policy and development assistance overlap as areas of policy formulation. (Section 5 – for space reasons, green bonds will not be examined).

- **Social policy:** A recent development is the emergence of *Social Impact Bonds* (SIBs). They are not really bonds, but a new type of financial instrument that has so far been used mainly in English-speaking countries. It is sold to investors and the proceeds are used to finance a particular social intervention with defined outcomes, e.g. reducing youth unemployment in a specific community. If these outcomes are achieved, the investor is repaid by the government, plus a return on their investment. This is supposed to lead to savings for the public sector. (DIBs are a variation of this instrument for development purposes, see Section 6.)
  
- **Macro-economic policy (in the EU):** Instead of using Keynesian fiscal policy, i.e. targeted government spending, to stimulate investment and growth at a time of crisis, the European Commission is thinking about ways to mobilise private financial flows to stimulate investment from its current low level. An important example is the European Fund for Strategic Investment, which will try to use modest public funds to ‘leverage’ far larger amounts of private finance through guarantees.<sup>3</sup> (For reasons of space this will not be discussed further.)

---

3 See [http://ec.europa.eu/priorities/jobs-growth-and-investment/investment-plan\\_en](http://ec.europa.eu/priorities/jobs-growth-and-investment/investment-plan_en) and <http://www.eib.org/efsi/index.htm>.

### 3 What explains this trend?

Why are policy-makers increasingly seeking recourse to the private financial sector? This trend has not gone unnoticed by civil society organisations and there is much discussion, especially about private involvement in the construction, operation and financing of infrastructure. The tendency is to see these developments as instances of ‘financialisation’ (‘financialisation of infrastructure’, ‘financialisation of development aid’ etc.).<sup>4</sup> The increasing involvement of private financial investors is interpreted as a series of business-driven attempts to open up new spheres for profitable investment. Governments are merely complying with these wishes. This ignores or downplays the role of *political* circumstances and motives, especially attempts by policy-makers to cope with, or use, a situation in which deficit reduction and austerity are reducing the fiscal room for manoeuvre and redefining the role of government.

This paper suggests a more nuanced view. The key to understanding this trend does not lie in the interests and lobbying efforts of private business – although these play a role too – but in the interests and convictions of policy-makers and governments. When they promote private financial participation in a range of policy areas, they are also following their own agenda, not just that of the private sector. It is partly about adapting to a new situation, especially the squeeze on public budgets. However, some part of it is certainly also the result of an ideological conviction that the private sector is superior when it comes to delivering services. Misjudging the drivers of this process may lead activists to target the wrong actors. In this case, private financial institutions are not the primary drivers even though they also stand to profit.

#### Austerity and the increasing gap between fiscal resources and political challenges

Virtually every publication or comment on harnessing private finance states that doing so is attractive or necessary for governments at a time when fiscal resources or ODA are insufficient to deal with social, economic or environmental problems. An OECD paper on infrastructure investment, for example, declares:

“total global infrastructure investment requirements by 2030 for transport, electricity generation, transmission and distribution, water and telecommunications will come to USD 71tn. This figure represents about 3.5% of the annual World GDP from 2007 to 2030. There is a widespread

---

4 For example: G. Aitken, 2015, “Going For Broke: Why financialisation is the wrong fix for infrastructure,” Rosa-Luxemburg-Stiftung, Brussels Office; Counter Balance, 2015, <http://www.counter-balance.org/wp-content/uploads/2015/06/GOING-FOR-BROKE-web.pdf> (10 May 2016).

recognition that governments cannot afford to bridge these growing infrastructure gaps through tax revenues and aid alone, and that greater private investment in infrastructure is needed.”<sup>5</sup>

The gap between what governments can do with the financial resources at their disposal and what needs to be done is created and/or expanded by a fiscal squeeze and the budget consolidation policies in both developed and developing countries. This squeeze is further compounded by the fiscal effects of recession and conscious political efforts to bring down public debt levels (especially in the EU).

In the immediate post-crisis years, fiscal expansion – i.e. increase in public expenditure – was the norm across most countries in the world as governments sought to soften the blow from the financial crisis and prevent it from spilling over into a full-blown economic and social crisis. To this end they channelled funds into social protection and subsidies for industries (e.g. the car scrappage programmes that gave consumers financial incentives to get rid of their old cars and buy new, allegedly more fuel-efficient ones). In 2010, however, counter-cyclical fiscal policy was replaced by an emphasis on fiscal consolidation through cutting public expenditure – otherwise known as austerity – and increasing taxes on consumption. In 2012, this changed yet again as many countries went easier on austerity. Since then, there is no discernible dominant tendency in fiscal policy. However, fiscal consolidation will certainly remain important. Ortiz et al. predict that austerity will become the global norm again from 2016 onwards.

**Figure 1** Number of countries that contract public expenditure as % of GDP, 2008-20<sup>6</sup>



5 OECD, “Fostering Investment in Infrastructure: Lessons learned from OECD Investment Policy Reviews,” (Paris: OECD, 2015a), <http://www.oecd.org/daf/inv/investment-policy/Fostering-Investment-in-Infrastructure.pdf> (28 April 2016), p. 5. See also OECD, “Social Impact Investment: Building the Evidence Base,” (Paris: OECD Publishing, 2015b) p. 11.

6 Source: I. Ortiz, M. Cummins, J. Capaldo, K. Karunanethy, “The Decade of Adjustment: A Review of Austerity Trends 2010-2020 in 187 Countries,” (Geneva: International Labour Office, 2015, Extension of Social Security Series No. 53), p. 2. The authors used data from the IMF World Economic Outlook Database (April 2015). The majority of 2014 numbers and all numbers from 2015 onwards are IMF staff estimates.

## The financial environment: large pools of private savings and low interest rates

### Savings seeking investment

An important feature of the current financial environment is the existence of large and increasing pools of private savings that are desperately seeking opportunities for profitable portfolio investment, i.e. assets to invest in.

We can very roughly distinguish two types of private savings. First, the savings of working and middle-class households, i.e. their life and pension savings inasmuch as they are channelled into private pension funds or life insurance rather than public pay-as-you-go pension systems and savings accounts. They are major players in financial markets because they administer the savings of hundreds of millions of individuals.

In most countries pension funds are regulated by law and are required to invest 'conservatively', that is, to be risk-averse and either avoid riskier types of assets entirely, such as shares, or invest only a certain percentage of their portfolio in them. Of course, we are only talking about *financial* risks. There is usually no legislation that prescribes how these funds should take ecological or other non-financial risks into account. Typically, they invest in financially safe assets like government bonds. The fiduciary duties of pension fund managers usually also oblige them to focus solely on the financial return of their portfolios. Thus they rule out, or at least create barriers to, more socially or politically conscious investment strategies, as these tend to create higher financial risks. These so-called institutional investors have grown in absolute and relative terms recently, as shown in Box 1.

The second type of private household savings is (very) rich people's money, i.e. that part of family fortunes accumulated over generations or personal wealth of very highly paid individuals that is not held as cash or in the form of real estate. This money is typically administered on their behalf by professional investment funds that are not open to regular people. These funds are not subject to the same restrictions as pension funds and can invest in riskier, but potentially also more lucrative assets like company shares. 'Hedge funds' are an example for this kind of rich-people's-money investment vehicle.

However, for the purposes of this paper we will ignore these type of funds because they seem less important to the drive towards harnessing private finance.<sup>7</sup>

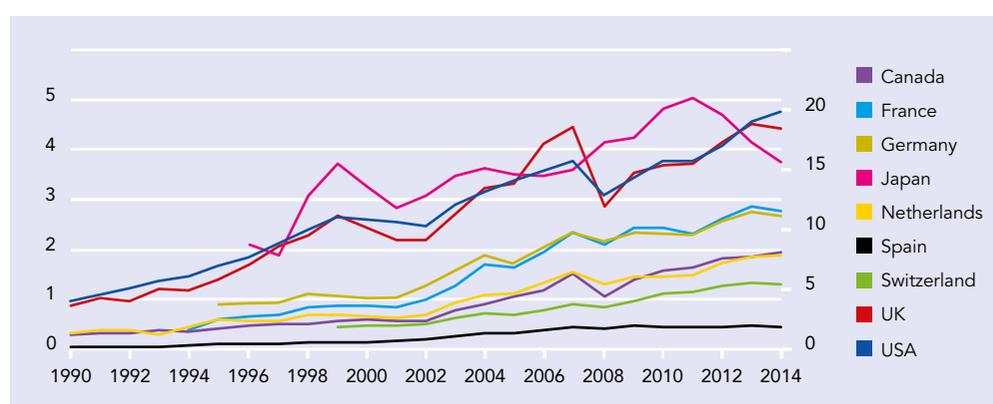
---

7 This assessment is based on the fact that they were never mentioned in the policy documents that were examined for this study.

### Box 1 Growth of pension funds and insurance companies<sup>8</sup>

Insurance companies and pension funds, the primary non-bank investment vehicles for working and middle-class households, have grown in size for a while and are predicted to grow even more over the coming years, at least in absolute terms.<sup>9</sup> The figures below illustrate this growth in terms of the absolute stock of financial assets managed by these institutional investors and in terms of the share of gross domestic product (GDP) in a number of selected countries. The latter illustrates how much they have grown in comparison to the size of the economy in which they operate.

**Figure 2 Assets under management in insurance companies and pension funds, in trillion US\$, selected countries (USA on right-hand axis)**

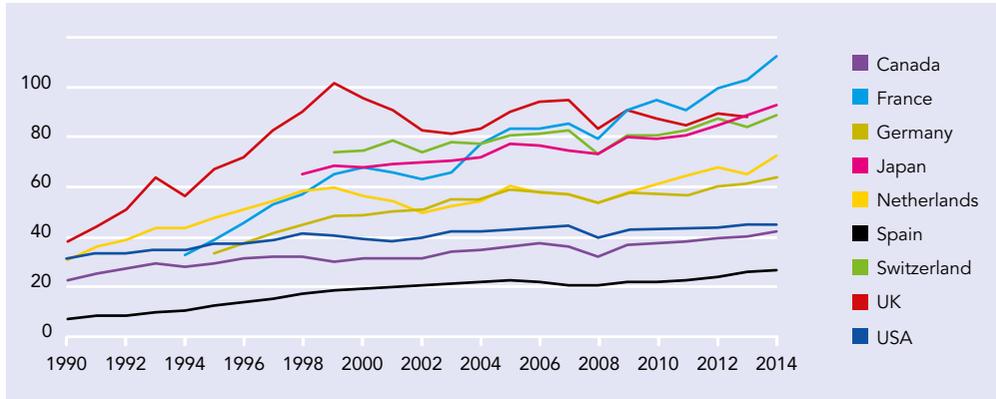


The OECD.Stat database does not provide one single number for assets under management, so these numbers include the following assets as provided by the OECD.Stat database: Currency and deposits, Debt securities, Loans, Equity and investment fund shares. This should come close to the way in which assets under management are normally calculated (although the 'loans' category is debatable). Assets are measured in US\$ at current prices. The numbers for the USA far exceed those of the other countries and were therefore shown separately on the right-hand axis.

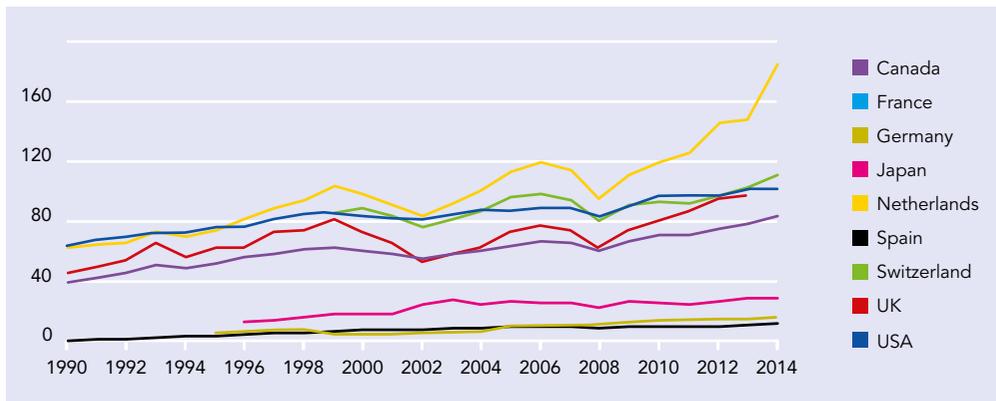
- 8 All data from the OECD.Stat Database, "Institutional Investors Statistics" ([http://stats.oecd.org/Index.aspx?DataSetCode=QASA\\_7II](http://stats.oecd.org/Index.aspx?DataSetCode=QASA_7II); accessed 25 April 2016). This dataset includes two data series: an older one that was discontinued after 2013, and a recent, ongoing one. Data from the latter was used where possible, but in most cases the discontinued data series goes back further in time. In order to obtain more data points, data from the two were therefore combined in the figures in this box. This introduces a number of breaks in the series.
- 9 "Over the next five years pension funds are expected to grow 26% from an estimated USD 28.4 trillion in 2014 to USD 35.8 trillion in 2019; insurance companies 33% from an estimated USD 28.2 trillion in 2014 to USD 37.7 trillion in 2019." Source: OECD, "Business and Finance Outlook 2015," (Paris: OECD, 2015c p. 78; see also pp. 88-90).

◉ **Box 1 Growth of pension funds and insurance companies**

**Figure 3 Total financial assets of insurance companies, % of GDP, selected countries**



**Figure 4 Total financial assets of pension funds, % of GDP, selected countries**

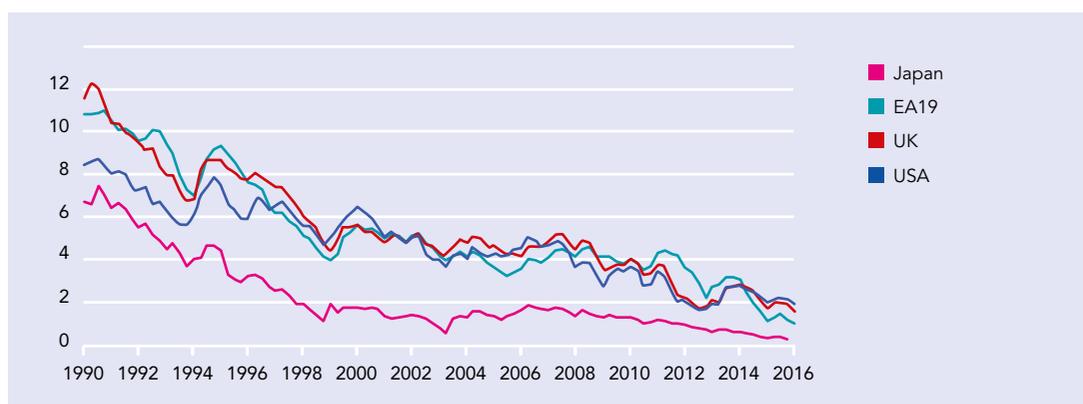


Data for France not available. 'Total financial assets' are not equivalent to 'assets under management' because the former include a number of asset categories that were deliberately excluded from the latter: for example, 'accounts receivable', to approximate what is commonly understood as 'assets under management'.

### Low interest rates and their consequences

Pension funds and insurers invest the money they receive from their clients into financial assets that generate the cash flows that finance the payouts to those clients. Traditionally, pension funds and insurers invest in financially relatively risk-free, interest-bearing securities, such as government bonds or very solid corporate bonds. These cash flows are sensitive to interest rates, which have been on a long-term downward trend for a while and have fallen more steeply since the financial crisis to levels close to zero (see Figure 5).<sup>10</sup>

**Figure 5 Long-term interest rates, % per annum, 1990Q1-2016Q1<sup>11</sup>**



The low interest rate environment means that returns on such assets are unusually low. This creates problems for life insurers and pension funds, which must honour their financial commitments to pension plan members and policy holders, many of which were agreed at a time when interest rates, and thus the return, on safe assets like bonds was generally higher. At the time, institutions were able to attract customers by promising them payouts that are now quite high compared to what institutions currently earn from their investments.<sup>12</sup>

A lot is at stake here. Pension funds and insurance companies are systemically important players in the financial markets, and many people have entrusted them with their savings, either voluntarily or because of the absence of a public option. Moreover, to make up for the shortfall in income, these institutions have begun making forays into riskier asset classes, especially infrastructure debt

10 At the time of writing (i.e. spring 2016), some governments are even able to issue government bonds at negative interest rates. Investors who buy them effectively *pay governments* for the privilege of lending them money, provided they hold them to maturity.

11 Source: OECD Data, Long-term interest rates (indicator), 2016, <https://data.oecd.org/interest/long-term-interest-rates.htm> (accessed 19 April 2016). Long-term interest rates are defined as yields on ten-year government bonds. "EA19" refers to the Euro-area, which currently includes 19 countries. No data for 2016Q1 for Japan.

12 As the OECD puts it: "The current low interest rate environment poses a significant risk for the long-term financial viability of pension funds and insurance companies, as they seek to generate sufficient returns to meet promises." (<http://www.oecd.org/newsroom/low-interest-rates-threaten-solvency-of-pension-funds-and-insurers.htm>, accessed 20 April 2016).

and corporate bonds,<sup>13</sup> which creates new risks. Last year the OECD warned that the “extent to which pension funds and insurance companies engage in a ‘search for yield’ is the main concern for their outlook. Pension funds (and insurance companies) may shift their portfolio allocation towards investments that could potentially fetch higher returns but in exchange for an increased overall risk profile for their investment portfolio.”<sup>14</sup>

Policy-makers have realised the problems, as well as the direction in which the industry is going, and have recently begun to facilitate/regulate this movement in a number of ways. (Unfortunately, strengthening public provision is not on the political agenda.) Efforts are underway to make unconventional assets more accessible, or ‘investable’, for pension funds and life insurers.<sup>15</sup> This would probably make these assets a permanent feature of the portfolios of pension funds and insurers.

In 2014/15, the EU also embarked on an ambitious project to create an integrated and more liquid capital market across all EU member states by 2019 – the so-called *Capital Markets Union*. This will include political initiatives that aim to direct household savings away from bank accounts and, where available, public pension schemes and into capital market-oriented investment or pension funds.<sup>16</sup> This can only work if these funds find enough assets to invest in that: (a) promise a decent return without being too risky; and (b) ideally match the long-term nature of their financial obligations through long-term returns. In other words, when the expansion of private pension provision is politically desired, the existence of a deep supply of investable assets becomes crucial. This could go beyond merely making existing asset classes more ‘investable’ and into the creation of new types of assets (more in section 4).

## Neoliberal dominance

Although not an immediate cause of the trends described here, there can be no doubt that decades of neoliberal dominance and indoctrination have produced an ideological preference among many policy-makers for letting the market or the private sector take care of social and economic problems. For them, getting private finance on board to pay for infrastructure, for example, is not just a pragmatic choice in a fiscally difficult situation; it also is the plausible thing to do.

To summarise: On one side we have (a) public budgets that are squeezed by the consequences of the financial and economic crisis as well as austerity policies; and (b) social and ecological problems,

---

13 “US life insurers shaken by rock-bottom rates,” *Financial Times*, 2 March 2016, <http://www.ft.com/cms/s/0/c25a41d4-dc9a-11e5-827d-4dfbe0213e07.html?siteedition=uk#axzz41pY0LNGB> (accessed 20 April 2016).

14 OECD (2015c), p. 120.

15 For example, the EU’s recently introduced Solvency II directive allows insurers to use riskier assets as benchmarks for calculating their outstanding obligations (liabilities) on certain customer contracts, rather than obliging them to apply the returns on usually risk-free assets like government bonds. This will bring down the book value of these obligations. (Information on Solvency II can be found here [http://ec.europa.eu/finance/insurance/solvency/solvency2/index\\_en.htm](http://ec.europa.eu/finance/insurance/solvency/solvency2/index_en.htm), and in “Q&A: How Solvency II works,” *Financial Times*, 3 January 2016, <http://www.ft.com/cms/s/0/51bc0c08-aa38-11e5-9700-2b669a5aeb83.html#axzz41CXOQzyo>).

16 More on Capital Markets Union: <http://www.finance-watch.org/our-work/dossiers?fid=174>; [http://www.somo.nl/publications-en/Publication\\_4232](http://www.somo.nl/publications-en/Publication_4232).

as well as gigantic challenges in the fields of development and infrastructure, that require long-term resource commitments well beyond the current capacity of government budgets. This creates (c) a funding mismatch between what needs to be done and what can be done with existing public resources.

On the other side we have: (d) large and increasing pools of household savings, especially pension savings, which are privately administered by investment funds. A low interest rate environment (e) renders the preferred assets of those funds – relatively risk-free interest-bearing securities – less profitable, creating (f) a funding mismatch between their assets and their obligations to clients. This sends funds on (g) a desperate and potentially risky ‘search for yield’, i.e. for assets to finance their long-term obligations to their clients.

Add to this mix (h) the factual and ideological power of neoliberalism with its preference for private sector approaches and hostility towards public sector solutions, and the result is a string of attempts to close funding mismatches (c) and (f) by combining them. This is done by creating financing arrangements that let private investors pour money into the provision of what used to be government tasks, thereby providing the required financing for those tasks and earning themselves a nice, stable income to fund their own obligations. Sections 4 to 6 present and discuss some of these attempts.

## 4 Instruments and regulatory measures to harness private finance for infrastructure projects

Infrastructure financing is probably the largest and most important case of harnessing private finance. In the EU in particular, a specific infrastructure-related bond has been created to ‘leverage’ private finance, but there are also regulatory measures that try to facilitate private financing of infrastructure without the involvement of public money. This section presents and discusses these in turn.

### Project Bonds: A ‘first loss’ funding instrument for infrastructure in the EU

The *Europe 2020 Project Bond Initiative* was launched by the European Commission in 2011 as part of the ‘Europe 2020 Strategy for smart, sustainable and inclusive growth’.<sup>17</sup> The stated aim is “to revive and expand capital markets to finance large European infrastructure projects in the fields of transport, energy and information technology”. To date, nine projects have been or are being supported – the first one beginning in 2013 in Spain – and two more are in the pipeline. The pilot phase of the initiative is now over and experiences from that first batch of projects are being evaluated.<sup>18</sup>

The Project Bond Initiative exemplifies the connection between squeezed budgets and attempts to harness private finance. It is worth quoting at length from a recent Commission document to illustrate the background and motivation for this kind of arrangement:

*“Following the 2008 financial crisis, government spending on infrastructure projects reduced significantly, while banks were confronted with growing constraints on their lending capacity for financing long term infrastructure projects. At the same time, debt capital market financing, as an alternative source of financing for greenfield infrastructure, fell to record low levels. There was thus a need to find ways to promote private sector financing of infrastructure projects without increasing public indebtedness.*

*Institutional investors [...] with the right support were seen as a potential solution to fill in the infrastructure finance gap. In this context, the Project Bond Initiative was intended to facilitate institutional investment and provide a credible alternative to the traditional bank lending to projects [...] by attracting institutional investors seeking the comfort of well rated investments. The initiative was thus designed to bridge the gap between the typically low investment grade ratings of privately financed*

17 See [http://ec.europa.eu/economy\\_finance/articles/consultation/europe\\_2020\\_en.htm](http://ec.europa.eu/economy_finance/articles/consultation/europe_2020_en.htm) (accessed 26 April 2016).

18 See [http://ec.europa.eu/economy\\_finance/financial\\_operations/investment/europe\\_2020/index\\_en.htm](http://ec.europa.eu/economy_finance/financial_operations/investment/europe_2020/index_en.htm) (accessed 26 April 2016).

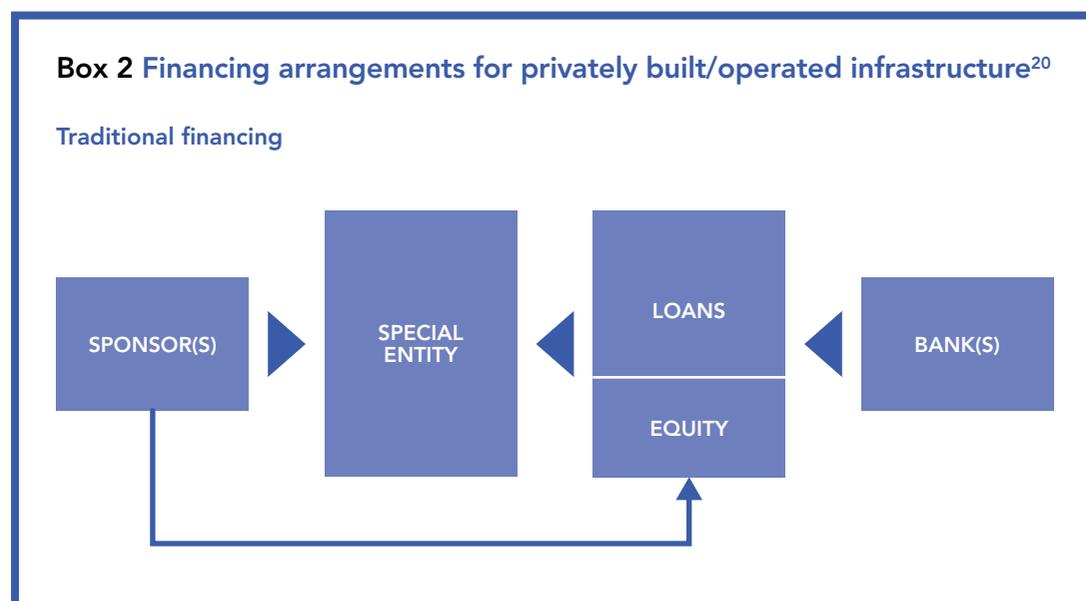
*infrastructure projects and the higher ratings targeted by institutional investors, by raising the credit quality of project bonds issued by project companies.”<sup>19</sup>*

### How do EU project bonds work and what are the goals?

The following parties are involved in a project bond:

- ▣ the European Commission
- ▣ the European Investment Bank (EIB), an international financial institution owned by EU member states
- ▣ the project company, a joint venture set up by a group of companies, the ‘sponsors’, with the specific purpose of constructing and/or operating a particular piece of infrastructure, e.g. a toll road
- ▣ institutional investors who buy the project bonds.

Box 2 shows how these parties interact and how this new financing arrangement, which involves capital market actors, differs from the more traditional (and simpler) financing arrangement for infrastructure constructed under Public-Private-Partnerships (PPPs). The latter only involves the sponsors and commercial banks as capital providers.

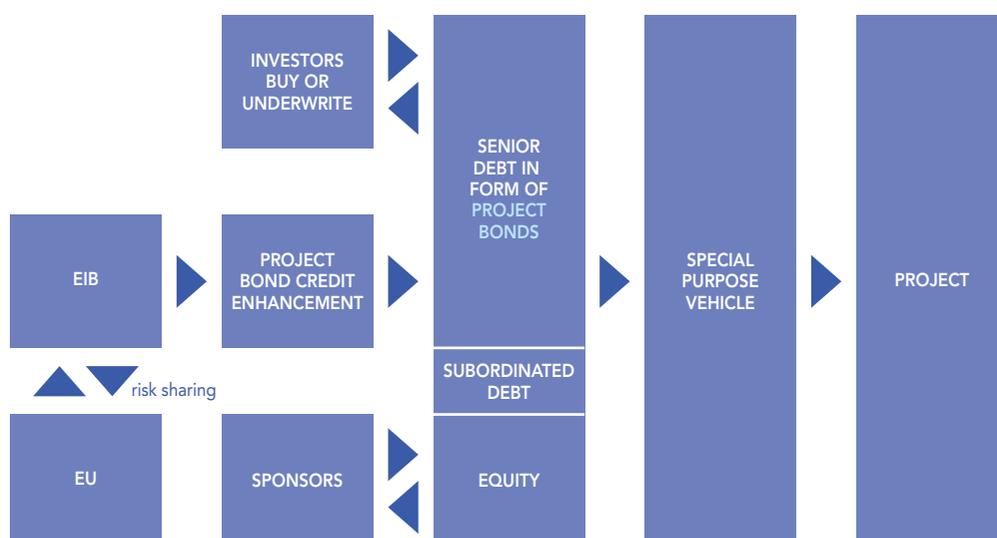


19 European Commission, “Commission Staff Working Document on the Ad-hoc Audit of the Pilot Phase of the Europe 2020 Project Bond Initiative,” SWD (2016) 58 final, 7 March 2016, pp. 3-4 (emphasis added), [http://ec.europa.eu/dgs/economy\\_finance/evaluation/pdf/eval\\_pbi\\_pilot\\_phase\\_sw\\_d\\_en.pdf](http://ec.europa.eu/dgs/economy_finance/evaluation/pdf/eval_pbi_pilot_phase_sw_d_en.pdf) (accessed 26 April 2016).

20 See [http://ec.europa.eu/economy\\_finance/financial\\_operations/investment/europe\\_2020/project\\_example\\_en.htm](http://ec.europa.eu/economy_finance/financial_operations/investment/europe_2020/project_example_en.htm) (accessed 26 April 2016).

## Box 2 Financing arrangements for privately built/operated infrastructure

### Credit-enhanced project Bond financing



Under the traditional model, the sponsors create and provide equity capital to the project company, which then raises additional debt capital through bank loans. Portfolio investors are not involved. Project bond financing is more complex. It has existed in some form for a while, but the innovative part of this initiative is the 'credit-enhancement'. Sponsors still provide equity capital, but the additional debt capital is divided into different tranches and now involves bonds sold to portfolio investors. In the pilot stage of the initiative, the Commission allocated €230 million from its budget as capital to the EIB. On that basis, the EIB provides either *subordinate* loans or credit guarantees to eligible project companies which then issue senior debt in the form of project bonds to raise more finance for the project.

'Subordinate' means that these loans are first in line to suffer losses in case the project encounters financial problems; that is, they are the first not to receive debt repayments from the project company, whereas holders of senior debt can still expect to be repaid even when things go badly. When a guarantee instead of a loan is given, no money changes hands upfront, but when things go wrong the money pledged in the guarantee is drawn upon to cover funding shortfalls in the project itself or to ensure that senior debt is serviced. In both cases, the senior debt/project bonds are 'credit-enhanced' because they are made less risky. They receive a higher, i.e. 'investment grade', credit rating and thus become potentially attractive to risk-averse institutional investors.

The hope is that this way the amount of financing that can be raised for infrastructure projects is increased substantially even though only a modest amount of public funds is committed and put at risk.

Both the EIB and the Commission provide funds to this financing facility, but, crucially, the Commission's capital contribution "serves as a 'first-loss' cushion".<sup>21</sup> When a default on the subordinated loans occurs, or when the guarantees are triggered, the budget committed by the Commission absorbs the first losses, up to a certain level. Losses in excess of this level are absorbed by the EIB, but because first losses are borne by the EU budget, the risk for the EIB is reduced, which should allow it to lend more to infrastructure project companies. There would thus be a dual leverage effect: the Commission's first loss contribution allows the EIB to make more subordinated loans, which allow the project companies to raise more private capital through credit-enhanced project bonds. According to the Commission, this would create a multiplier effect of 15-20, which means that investment sums of up to 15-20 times the amount of the Commission's contribution could be raised, i.e. €4.6 billion.<sup>22</sup>

Apart from 'leveraging' modest public funds to get infrastructure investment and growth going in times of austerity, the Project Bonds Initiative also aims to create a win-win situation by creating a financial instrument that matches the need for long-term financing for infrastructure project companies with institutional investors' need for long-term assets.

### Problems and risks

Project Bonds obviously only make sense where the construction and/or operation of infrastructure is already privatised, or more precisely: where it is partly delegated to private sector providers in the context of a PPP. A lot has already been said about the risks of PPPs and the commercialisation of what often used to be public provision – for example, that it leads to a bias in favour of environmentally irresponsible mega-projects and fossil fuel infrastructures.<sup>23</sup> These are important concerns, but this analysis focuses on the *financing* mechanisms, so the project-level risks of PPPs will not be covered here.

Civil society organisations have long argued that governments' attempts to entice the private sector to engage in the provision of infrastructure will lead them to give too many guarantees, subsidies or tax incentives to private actors. This, they argue, will potentially relieve private businesses of too many of the risks of doing business, e.g. the risk that revenues from an infrastructure facility that charges user fees fall short of projections.<sup>24</sup> This risk is even higher in countries where governance

21 European Commission, "Commission Staff Working Document on the Ad-hoc Audit of the Pilot Phase of the Europe 2020 Project Bond Initiative," SWD (2016) 58 final, 07 March 2016, p. 4.

22 European Commission, The pilot phase of Europe 2020 Project Bond Initiative (reissue), MEMO/11/370, 23 May 2012, [http://europa.eu/rapid/press-release\\_MEMO-12-370\\_en.htm?locale=en](http://europa.eu/rapid/press-release_MEMO-12-370_en.htm?locale=en) (accessed 26 April 2016).

23 For example: Heinrich Böll Foundation North America/LatinDADD (eds.), "Infrastructure: for people or for profit?," 2014, <https://us.boell.org/sites/default/files/infrastructure-final.pdf> (accessed 28 April 2016); N. Hildyard, *Public-Private Partnerships, Financial Extraction and the Growing Wealth Gap: Exploring the Connections*, 2014, <http://www.thecornerhouse.org.uk/resource/PPPs-extraction-wealth-gap> (accessed 11 May 2016).

24 For example: A. Caliarì, "Relying on institutional investors to finance infrastructure: Forces which pose risks to public debt and budgets," in: Heinrich Böll Foundation North America/LatinDADD (eds.), 2014, pp. 19-20.

capacities and control mechanisms are weak and/or where bribing officials is easy or commonplace.<sup>25</sup> This would leave private providers with a relatively risk-free opportunity to make a profit at the expense of the public purse, which remains or becomes the ultimate risk bearer.

If, on top of that, private provision of infrastructure is to be financed through complex structures like bonds, another layer of risk and guarantees could be added. These financing structures are not cheap because they involve a higher number of actors whose services need to be remunerated. In the case of bonds these include rating agencies and, on the side of the institutional investors who buy these bonds, usually an asset manager who administers the fund's money on its behalf and usually earns a fixed fee for his/her services as well as a cut of the profits from the assets they manage. Perhaps more capital can be raised in this way than through bank loans, but this capital is also more expensive. If a government feels compelled to give guarantees to a project company to ensure that it will be able to meet its payment obligations, including to bond holders, it gives rise to a contingent liability in the public balance sheet that matches the higher cost of capital. In short: fiscal risks will be higher.

It is too early to tell whether Project Bonds or similar infrastructure-related financial instruments will come to developing countries. However, the intention is already there. A January 2015 OECD paper that spells out what developing countries should do to attract more PPP investment also discusses the question of financing, including the involvement of pension funds and insurance companies. It suggests the development of "appropriate investment vehicles to access long-term investments", the promotion of "infrastructure as an asset class for long-term investors" and the use of public sector finance to "leverage private sector finance".<sup>26</sup> This follows earlier work at the OECD that had resulted in the "G20-OECD High-level Principles of Long-term Investment Financing by Institutional Investors".<sup>27</sup>

The paper also highlights the obstacles to getting institutional investors to provide debt capital to developing country infrastructure (low credit ratings). However, there is clear political momentum behind this initiative, so there will probably be attempts to overcome these obstacles and devise a financial instrument for the developing country context. If these materialise, developing countries will be at higher risk of exposure to volatile cross-border capital flows in future.

---

25 In Lesotho, for example, a public hospital was built under a PPP agreed in 2009. This project, which was supposed to benefit from superior private sector efficiency, cost the government much more than anticipated, partly as a result of poorly designed contracts that burdened it with excessive obligations towards the private company. Apparently, the contract, which the International Finance Corporation helped structure, even projected a stunning 25 per cent return on equity for the project company's shareholders! (Oxfam, "A Dangerous Diversion: Will the IFC's flagship health public-private partnership bankrupt Lesotho's Ministry of Health?," 2014, Oxfam Briefing Note 7 April 2014, [https://www.oxfam.org/sites/www.oxfam.org/files/file\\_attachments/bn-dangerous-diversion-lesotho-health-ppp-070414-en\\_0.pdf](https://www.oxfam.org/sites/www.oxfam.org/files/file_attachments/bn-dangerous-diversion-lesotho-health-ppp-070414-en_0.pdf), accessed 11 May 2016, p. 7.

26 OECD (2015b), p. 23.

27 September 2013, <http://www.oecd.org/daf/fin/private-pensions/G20-OECD-Principles-LTI-Financing.pdf> (accessed 28 April 2016). More on the G20/OECD work on institutional investors and long-term investment here: <http://www.oecd.org/daf/fin/private-pensions/institutionalinvestorsandlong-terminvestment.htm>.

## The broader context: turning infrastructure into an asset class

Bonds and credit enhancement are not the only means of expanding private sector financing for infrastructure. There are also regulatory measures to support the establishment of 'infrastructure assets' as an officially recognised asset class.

Actual investment in infrastructure assets by institutional investors is low compared to potential demand for them. Those who participated in an OECD survey of large pension funds only held 1.1 per cent of their assets under management in infrastructure-related assets (in absolute terms: US\$ 85.6 billion in US\$ 7.7 trillion worth of total assets), despite a desire to invest more.<sup>28</sup> Of course, there are many infrastructure facilities that deserve to be built, but there is a dearth of *investable* infrastructure projects. "Critics say governments often come up with a list of projects but fail to do enough work to convince risk-averse investors that the project will happen or make the returns needed."<sup>29</sup> Three general types of obstacles to investability are usually mentioned: the general business risk of infrastructure, e.g. the risk that revenues are lower than projected; political risks that arise because governments might change conditions, user fees etc.; and a lack of standardisation. Therefore, policy-makers and governments are now exhorted to work on these obstacles to make infrastructure more attractive as an investment.

Apart from project bonds, the EU is also using its prudential regulations for investment funds and insurances to boost the uptake of infrastructure-related investments by defining them as a specific asset class with a capital requirement that reflects the allegedly lower risk of such assets. A currently pending amendment to the Solvency II directive, the EU's regulatory framework for insurance companies, will define infrastructure investments as a specific asset class that benefits from a slightly lower risk factor. No 'leveraging' of public money takes place in this case. The purpose is simply to make investing in these assets cheaper and to boost investment.

---

28 OECD, "2015 Annual Survey of Large Pension Funds and Public Pension Reserve Funds," 2016, pp. 19-21. See also McKinsey & Company, "Rethinking Infrastructure: Voices from the Global Infrastructure Initiative," 2014, [http://www.mckinsey.com/~media/mckinsey/dotcom/client\\_service/infrastructure/pdfs/gii%20compendium/rethinkinginfrastructure\\_gii.ashx](http://www.mckinsey.com/~media/mckinsey/dotcom/client_service/infrastructure/pdfs/gii%20compendium/rethinkinginfrastructure_gii.ashx) (accessed 9 May 2016), pp. 13-26.

29 'Infrastructure: Bridging the gap', *Financial Times*, 10/11/2016, p. 7.

## 5 'Leveraging', 'blending' and 'catalytic' funding in development assistance

Reflecting a growing perception that “traditional sources of development financing, in particular official development assistance (ODA), are not sufficient to address the scale and complexity of today’s global development challenges”,<sup>30</sup> development discourse recently shifted from a focus on public finance to the question of how best to use private-public financing arrangements in development assistance to mobilise additional resources. While the former dominated the discussion around the Millennium Development Goals (MDGs), the latter has been the focus of the Sustainable Development Goals (SDGs) and in particular the Third International Conference on Financing for Development in Addis Ababa in 2015. This corresponds to an increase in the engagement of development donors/institutions with private sector actors.

In this context ‘leveraging’, ‘blending’ and ‘catalytic’ funding have become the new buzzwords. ‘Green’ investment and infrastructure are specifically named as areas where blending could be used to benefit developing countries and the environment. The Addis Ababa resolution states that ODA could be used to “catalyse additional resources” from private and public sources and to “unlock additional finance through blended or pooled financing and risk mitigation”.<sup>31</sup> It also calls on multi-lateral development banks “to further develop instruments to channel the resources of long-term investors towards sustainable development, including through long-term infrastructure and green bonds” and states “that regional investments in key priority sectors require the expansion of new financing mechanisms” (para. 75).

‘Blending’ public and private finance is not new. Development banks have been doing it for a long time. This section will therefore present one of the newer initiatives that use government money to ‘catalyse’ additional financial resources from portfolio investors.

### Climate public-private partnerships in the UK

In January 2012, the UK government announced a new initiative that would “bring major private investment to help tackle the global threat of climate change and help boost economic growth”.<sup>32</sup> This so-called Climate Public Private Partnership, or CP3, uses UK government money to foster investment in low-carbon and energy-efficient projects in developing countries and to “demonstrate to private sector investors that climate friendly investments in developing countries are financially

30 OECD (2015b), pp. 22-3.

31 United Nations, “Resolution adopted by the General Assembly on 27 July 2015: Addis Ababa Action Agenda of the Third International Conference on Financing for Development (A/RES/69/313),” [http://www.un.org/ga/search/view\\_doc.asp?symbol=A/RES/69/313](http://www.un.org/ga/search/view_doc.asp?symbol=A/RES/69/313) (accessed 4 May 2016), para. 54; also para. 45.

32 Press Release 27 January 2012, <http://webarchive.nationalarchives.gov.uk/20130128103201/http://dfid.gov.uk/documents/publications1/press-releases/private%20sector%20to%20tackle%20climate%20change.pdf> (accessed 4 May 2016).

viable”.<sup>33</sup> Through the UK’s International Climate Fund, the government injected £110 million into two commercially run private equity funds whose job it is (a) to raise additional money from private and other public sources like pension funds and sovereign wealth funds; and (b) to invest the money in low-carbon projects either directly or through investments in other funds (sub-funds). According to information released by the UK government in November 2015,<sup>34</sup> the two funds have attracted additional money from a range of other investors to the tune of US\$ 418 million and US\$ 391 million respectively. One of these funds has begun investing the money.<sup>35</sup>

In the case of this initiative, public money is not used to reduce the risks for other, private investors. Gains and losses will be shared equally between them and the UK government. (In other words: this is not a ‘first loss’ or credit-enhancing structure.) The goal is instead to send a ‘signal’ to institutional investors by demonstrating that commercially successful investment in climate-friendly projects and technologies is possible in the hope that this will encourage further private equity investment.<sup>36</sup> However, the initiative also includes a smaller grant (i.e. non-repayable) element of £20 million in the form of a ‘Technical Assistance and Project Development Facility’ to select and develop projects to be financed under the CP3.

According to research by the British charity CAFOD, the CP3 programme is intended to run until 2023 or 2026. In the 12-15 years of its duration the programme will ‘receive an average equivalent to about 0.1 per cent of the UK’s annual aid budget’.<sup>37</sup> There is no financial risk to the UK government, as the money comes out of the ODA budget anyway. In fact, the UK essentially acts like a private investor with low risk aversion and may earn a commercial return. Apparently it intends to allocate returns from the programme to future development projects, and these allocations will count towards the UK’s ODA expenditure.<sup>38</sup> If the CP3 is a commercial success a certain (small) share of the UK ODA expenditure will thus finance itself and reduce the share of tax revenues that need to be allocated to meet the official ODA commitment of 0.7 per cent.

However, that does not mean the programme is without problems. CAFOD criticises what it calls the government’s “hands-off approach”.<sup>39</sup> Instead of being more directly involved in selection and oversight at project level, the government “delegates power to private equity funds to make decisions and collect information about the low-carbon investment it funds”.<sup>40</sup> The risk in what CAFOD rightly calls a combination of “private equity fund management with public policy

33 See [www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/480624/CP3\\_case\\_study.pdf](http://www.gov.uk/government/uploads/system/uploads/attachment_data/file/480624/CP3_case_study.pdf) (accessed 4 May 2016).

34 See [www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/480624/CP3\\_case\\_study.pdf](http://www.gov.uk/government/uploads/system/uploads/attachment_data/file/480624/CP3_case_study.pdf) (accessed 4 May 2016).

35 One of these two funds, the *Asia Climate Partners* fund, involves the Asian Development Bank and the Dutch asset managing firm Robeco Institutional Asset Management B.V. The latter’s job is to manage the fund’s investments (<http://www.adb.org/news/new-joint-venture-established-private-equity-investments-climate-related-transactions>; accessed 4 May 2016).

36 See [www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/48451/5720-business-case-for-icf-support-for-the-climate-publ.pdf](http://www.gov.uk/government/uploads/system/uploads/attachment_data/file/48451/5720-business-case-for-icf-support-for-the-climate-publ.pdf), p.1 (accessed 4 May 2016).

37 CAFOD, “*Investing in our future? Making the UK’s climate public-private partnership fit for purpose*,” 2015, <http://cafod.org.uk/content/download/24315/174594/file/Investing%20in%20our%20future.pdf>, p. 5.

38 See [www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/48451/5720-business-case-for-icf-support-for-the-climate-publ.pdf](http://www.gov.uk/government/uploads/system/uploads/attachment_data/file/48451/5720-business-case-for-icf-support-for-the-climate-publ.pdf), pp. 60-1.

39 CAFOD (2015), p. 8.

40 Ibid, p. 10.

objective"<sup>41</sup> is not that the public bleeds financial resources, but that commercial motives and conventional asset managers will subordinate ecological and development concerns to commercial ones in selecting and monitoring projects and their outcomes. In short: that they deliver financial return, but little else.

It is still too early to tell whether CP3s will be successful in financial terms and in attracting more private investment. There are, however, serious doubts whether they can make a useful contribution to long-term development financing in line with sustainability goals. Even so, there already appears to be "considerable interest in applying this investment model to other policy and programme areas".<sup>42</sup>

---

41 Ibid, p. 8.

42 Ibid, p. 8.

## 6 'Impact Investment': Social Impact Bonds and Development Impact Bonds

Unlike Project Bonds, Social Impact Bonds (SIBs) and Development Impact Bonds (DIBs) are genuinely new instruments. They tend to be targeted at investors who are not, or not solely, interested in the highest possible financial return, but would also like to see a 'social return'. This can include government agencies, philanthropic foundations or the very rich (often referred to as 'high net-worth individuals' or 'family offices') because they are free to take on more risk or forego profit making. However, it excludes traditional philanthropy, that is, the giving of grants without any expectation of getting the grant money back, let alone of making a profit. Conventional, or 'finance first', investors – such as institutional investors – are therefore more or less excluded from this area, at least for the time being.<sup>43</sup>

### How do Impact Bonds work?

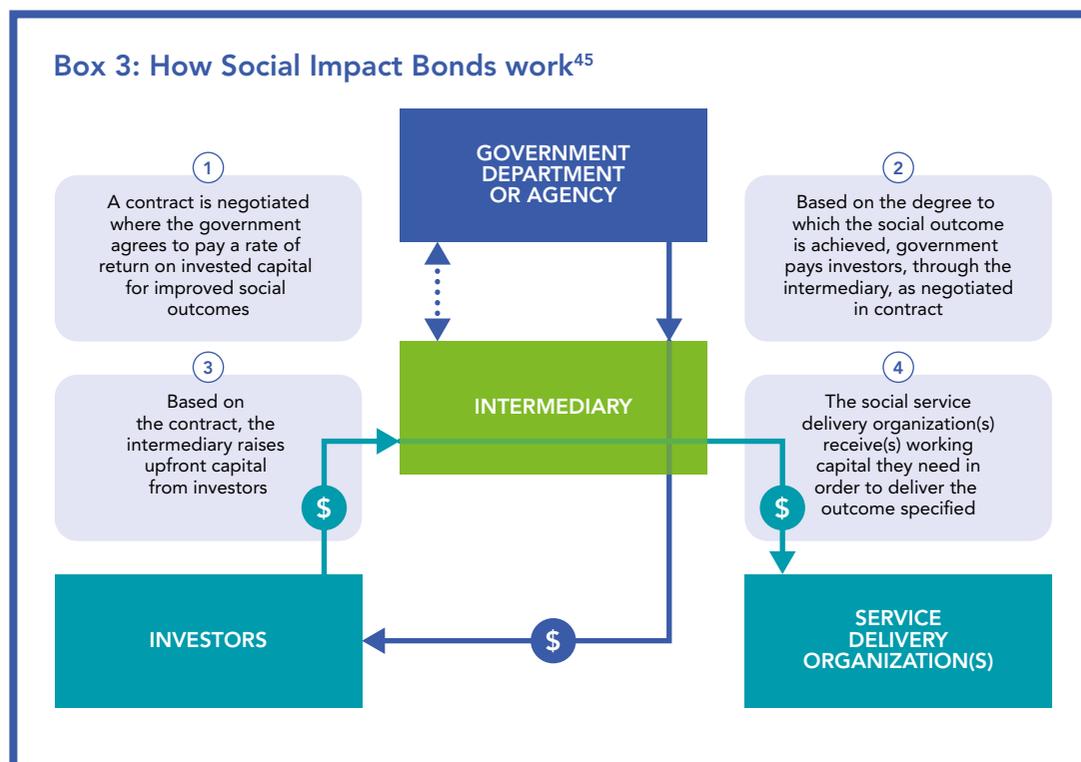
Despite their name, Impact Bonds are not really bonds at all because there is no underlying cash flow and no guaranteed (re)payment of interest and principal for buyers of these instruments. They follow the so-called 'pay for success' principle, which means that repayment depends on whether the project financed through their issuance achieves the social or development goals that were specified at the outset. If they are not achieved, or if they are not achieved in full, investors may only get back their money without a return, make a loss or even get nothing back at all.

More concretely, the commissioning party – a local or regional government in the case of SIBs, a foreign donor country, development finance institution or private foundation in the case of DIBs – identifies an area or problem in which it wants work done. To that end it collaborates with an intermediary who does the practical work of making contracts with all parties involved, structuring the investment and raising money from investors. The money is passed on to a non-profit service provider that uses it to finance its work in the designated area or project. An independent evaluator assesses whether the defined outcomes – for example, a reduction in recidivism rates among young offenders – have been achieved. If the project is deemed to have been successful, the commissioning party repays the initial investment plus a return, whereby the rate of return depends on how much was achieved. There is therefore no upfront commitment of financial resources by the government agency or other sponsor.

---

43 There are more details on the hybrid, i.e. neither philanthropic nor pure for-profit, nature of social impact investment in OECD (2015b).

The commissioning party benefits in two ways. First, pay-for-success means that the financial risk is transferred to the private investors. Second, if successful, the project should generate savings for it because the entire transaction should be structured in a way that the costs of repaying SIB/DIB investors are lower than what the commissioning party would otherwise have to spend. For example, a reduction in recidivism that is larger than what the government agency would have achieved on its own will lower incarceration costs.



44 However, the fact that a government does not pay anything at the beginning of an intervention does not necessarily mean that it has that money at its disposal now to put to a different use. Because payment obligations may arise in the future an SIB gives rise to a contingent liability against which the government may have to set money aside in the current budget, either to comply with accounting rules for (local) governments or with principles of fiscal prudence, which demand that contingent liabilities should not go unrecognised and unfunded. “The government, therefore, realizes no upfront savings to finance the program and is still limited by current operating budget constraints.” (K. McKay, “Evaluating Social Impact Bonds as a New Reentry Financing Mechanism: A Case Study on Reentry Programming in Maryland,” 2013, Office of Policy Analysis: Annapolis/Maryland, <http://mgaleg.maryland.gov/Pubs/BudgetFiscal/2013-Evaluating-Social-Impact-Bonds.pdf> (accessed 18 April 2016), p. 13.) If no such provisions are made in the budget there is a danger that SIBs might be used by governments to engage in risky ‘buy now, pay later’ off-balance sheet practices. See D. Whitfield, *Alternative to Private Finance of the Welfare State: A global analysis of Social Impact Bond, Pay-for-Success and Development Impact Bond project.* (Adelaide: Australian Workplace Innovation and Social Research Centre, 2015), p. 6.

45 Taken from Deloitte, “Paying for outcomes: Solving complex societal issues through Social Impact Bonds,” <http://www2.deloitte.com/content/dam/Deloitte/nl/Documents/public-sector/deloitte-nl-social-impact-bonds.pdf> (accessed 6 April 2016).

## The market for SIBs and DIBs

The first SIB was launched in the UK in 2010 by *Social Finance* ([www.socialfinance.org.uk](http://www.socialfinance.org.uk)). The goal of the programme was to reduce recidivism rates at Peterborough prison in Cambridgeshire. Two years later the instrument was introduced to the US in a project that involved global banking giant Goldman Sachs and focused on prisoner rehabilitation in New York City.<sup>46</sup> They have since become more widespread but are still a predominantly Anglo-American (plus Australia) phenomenon. Israel is the only other country to have a significant number of SIBs (See Table 1).

**Table 1 Impact Bonds Worldwide<sup>47</sup>**

Country	Impact Bonds in design stage	Impact Bonds in implementation stage
UK	8	25
USA	7	12
Austria	0	1
Belgium	0	1
Finland	1	1
Germany	0	1
Ireland	0	1
Portugal	0	1
Netherlands	0	2 <sup>48</sup>
Switzerland	0	1
Australia	1	2
Canada	0	1
Colombia	1	0
Chile	1	0
Uganda	1	0
Israel	3	2
India	0	1
Mexico	1	0
New Zealand	1	0
South Africa	1	0
South Korea	0	1
<b>TOTAL</b>	<b>27</b>	<b>53</b>

- 
- 46 Princeton University, "Social Impact Bonds: A New Tool for Social Financing," 2014, <http://www.princeton.edu/sites/default/files/content/Social%20Impact%20Bonds%202014%20Final%20Report.pdf> (accessed 4 April 2016), p. 8.
- 47 Source: <http://www.instiglio.org/en/sibs-worldwide/> as of 5 April 2016. See also J. Loxley and P. Marina, "Social Impact Bonds: An Update," Canadian Centre for Policy Alternatives, 2015, <https://www.policyalternatives.ca/sites/default/files/uploads/publications/Manitoba%20Office/2015/01/Social%20Impact%20Bond%202015%20FINAL.pdf> (accessed 6 April 2016). This table probably misses out some projects, but it seems the most comprehensive data source available.
- 48 According to the Dutch bank ABN AMRO (2015) there were already three Dutch SIBs in October 2015 ("Social Impact Bonds – October 2015: Opportunities and challenges in the Netherlands," p. 58; [https://www.abnamro.com/en/images/Documents/040\\_Sustainable\\_banking/ABN\\_AMRO\\_Rapport\\_Social\\_Impact\\_Bonds.pdf](https://www.abnamro.com/en/images/Documents/040_Sustainable_banking/ABN_AMRO_Rapport_Social_Impact_Bonds.pdf); accessed 11 April 2016).

In financial terms, the volumes are quite small, even in the UK and the US. According to the Instiglio database on SIBs, the outcome payments on *all* SIBs in the UK where data is available amount to roughly £80 million and to about US\$ 123 million in the US. The investment sums needed or raised amount to £32.4 million and US\$ 135 million respectively.<sup>49</sup> The largest individual SIB by far required or raised US\$ 30 million, while the smallest ones are just slightly above the 100,000 Pounds or Euros range. In the financial industry this is below negligible. To put it in perspective: the total market capitalisation of just one firm listed on the Amsterdam stock exchange, the Heineken N.V. brewery, amounted to €45.5 *billion* (on 5 April 2016).

There is little to say so far about the financial returns that investors can expect. However, it seems safe to say that, at least for now, they are well below the rates that can attract the interest of ‘finance first’ investors (especially given the high risk of not being paid at all). SIB contracts generally define a maximum annual return to be paid out in case a project is successful. These are predominantly in the medium single-digit range, but can go as low as 3 per cent in the case of the single German SIB and, in one very exceptional UK case, as high as 30 per cent.<sup>50</sup> Social Finance, the organisation behind the first ever SIB, states that returns to investors on this SIB will range between 2.5 per cent and 13 per cent.<sup>51</sup> A recently announced SIB in Saskatchewan, Canada provides a 5 per cent return to investors if project goals are achieved.<sup>52</sup> However, even this might be optimistic. According to research commissioned by the City of London in 2013, expected *actual* returns for SIBs ranged between 2 per cent and 4 per cent, although this number may now be outdated.<sup>53</sup>

Even less can be said about Development Impact Bonds (DIBs) because they have barely been tested. Reliable information is difficult to come by, but there seem to be less than a handful of DIBs. The first was launched in Rajasthan, India, in 2014 and will run from 2015 to 2018. An investment sum of US\$ 267,000 was raised that went to an NGO tasked with improving learning outcomes and school enrolment for girls. Depending on the rate of success, investors can earn a maximum return of 15 per cent.<sup>54</sup> In 2014, the UK government declared its intention to launch a DIB in Uganda to invest in the prevention of sleeping sickness,<sup>55</sup> and there also appears to be an operational DIB in Peru.<sup>56</sup>

---

49 This understates the real amounts because financial data is not available for all SIBs, but even if they were included the general impression of a small market would remain (see also <http://www.brookings.edu/research/interactives/2015/upfront-capital-commitments-social-impact-bonds>).

50 Brookings, “The potential and limitations of impact bonds: Lessons from the first five years of experience worldwide,” 2015, p. 19-20, <http://www.brookings.edu/~media/Research/Files/Reports/2015/07/social-impact-bonds-potential-limitations/Impact-Bondsweb.pdf?la=en> (accessed 12 April 2016).

51 Social Finance, “A New Tool for Scaling Impact: How Social Impact Bonds Can Mobilize Private Capital to Advance Social Good,” 2012, <http://www.socialfinance.org.uk/wp-content/uploads/2014/05/small.SocialFinanceWPSingleFINAL.pdf> (accessed 6 April 2016), p. 9.

52 Loxley/Puzyreva (2015), pp. 5-6.

53 City of London, Growing the Social Investment Market: The Landscape and Economic Impact, 2013, <https://www.cityoflondon.gov.uk/business/economic-research-and-information/research-publications/Documents/research-2013/Growing-social-investment-market.pdf> (accessed 6 April 2016), p. 24.

54 See <http://instiglio.org/educategirlsdib/wp-content/uploads/2015/09/Educate-Girls-DIB-Sept-2015.pdf>

55 See <https://www.gov.uk/government/news/uk-development-bonds-will-combat-global-poverty>

56 ABN AMRO (2015), pp. 44-46.

More are apparently in the pipeline thanks to interest from a number of development institutions, banks and other actors, such as the Multilateral Investment Fund of the Inter-American Development Bank.<sup>57</sup>

## Some problems of the Impact Bond model

It is too early to tell whether Impact Bonds will become quantitatively significant in the sense of making up a significant share in the portfolios of institutional investors and making a significant contribution to social policy and development funding. This will depend on whether they can become more standardised and more commercially attractive, whether a market for them can be created that allows investors to liquidate their holdings, and whether the many methodological problems in assessing the savings for governments can be satisfactorily solved. Making Impact Bonds a mainstream financing instrument will at the very least require large initial efforts in the form of upfront investment, subsidies and guarantees as well as technical assistance from governments and other donors that are not, or not primarily, financially motivated.

Currently the obstacles to making SIBs a financing instrument that will deliver an attractive and relatively risk-free return to institutional investors *and* measurable cost savings for the public sector appear formidable. Listing all the obstacles would take too much space, so this section focuses on just two: high complexity and small financial scale.

### Complexity

Impact bonds are very complex. This problem may diminish over time as the actors get used to the new procedures, but some of the complexity is simply inherent to these instruments. There is, for example, the problem of measuring outcomes, attributing them to the project in question and assessing the savings for the public sector. The latter two are particularly difficult thanks to the messiness and complexity of human societies that makes it difficult to identify causes and effects. For example, is a project to reduce youth unemployment successful because of the work done by the service provider or because of a simultaneous increase in economic growth?

Assessing public cost savings is equally difficult because it requires comparison with an alternative scenario or an appropriate control group. These problems are probably not insurmountable, but dealing with so much complexity will be a considerable cost factor because standards, scenarios and indicators will have to be agreed and possibly adjusted mid-project to allow for changing circumstances. Moreover, the highly specific nature of each social policy problem and intervention makes standardising indicators difficult so that they would have to be adjusted for each individual project, adding to complexity and cost.<sup>58</sup>

57 See <http://www.fomin.org/en-us/Home/News/PressReleases/ArtMID/3819/ArticleID/1097/MIF-to-test-innovative-Social-Impact-Bonds-financing-model-in-Latin-America-and-the-Caribbean-.aspx>.

58 'High transaction costs' are regularly identified as one major obstacle in developing the SIB market or social impact investing more generally. e.g. City of London (2013), p. 29; OECD (2015b), p. 24.

Yet another factor that increases complexity is the comparatively high number of involved parties: the commissioning body, the intermediary, the investors, the project provider and the independent evaluator. This makes for cumbersome contract negotiations and performance monitoring.

### Scale

Bond financing only makes economic sense from a certain scale upwards to justify the effort and cost of defining, standardising and structuring these financing arrangements. The small financial volume of individual projects that are eligible for SIB or DIB financing therefore creates problems. Unlike infrastructure projects, social policy interventions do not tend to require very large sums of money to finance them. The considerable cost of setting up a SIB/DIB-financed project compares unfavourably with the small volume of money to be raised. It also means that the number of bonds that can be issued in connection with a particular project is too small from a potential investor's point of view to make buying them worth the costs of due diligence.<sup>59</sup>

If Impact Bonds cannot be made truly commercially viable, governments or other donors might be tempted to adjust the terms and conditions of specific impact bonds to make them artificially attractive through guarantees, lowering the bar for payouts to investors or similar measures. This would depend on how ideologically committed the government in question is to the particular project and this particular form of financing. If neither commercial viability nor sufficient government commitment to make them artificially attractive can be guaranteed, investing in Impact Bonds will probably be left to so-called 'impact first' investors, i.e. those ethically motivated investors for whom financial return is secondary to 'social return'. In this case, Impact Bonds would remain a niche product at least in the short to medium term. From a public interest angle, this would not be the worst outcome because it would probably mean that they would not become a normal pillar of social policy and development financing, and they would be restricted to projects that would not have taken place otherwise.

The worst case scenario would clearly be if an economically inefficient instrument was artificially made viable by governments that believe in the superiority of private sector provision as an article of faith, even if it means relieving private financial investors of too many risks. Alternatively, pooling impact bonds in packaged financial instruments and/or centralising social policy interventions under the roof of one organisation could possibly deal with the problem of scale and make Impact Bonds more viable. Ideologically determined governments might use this as an argument to move further towards commercialisation and privatisation. SIBs could eventually become real bonds issued by commercial 'social enterprises' that specialise in social policy interventions paid for by the government.<sup>60</sup> The risk of privatisation by stealth, though merely a glimmer on the political horizon at the moment, cannot be ruled out. Needless to say, this would fundamentally change how and to whom such services are provided.

---

59 "Another challenge in engaging mainstream investors is the *lack of sufficient absorptive capacity for capital* [...]. There is a scarcity of high quality investment opportunities into which larger amounts of capital can be deployed." OECD (2015b), p. 38.

60 A similar scenario is in fact hinted at in ABN AMRO, "Social Impact Bonds: Opportunities and challenges for the Netherlands," 2013, p. 15, <https://insights.abnamro.nl/app/uploads/2013/10/Social-Impacts-Bonds-rapport.pdf> (accessed 7 April 2016).

#### Box 4: SIBs in the Netherlands

In Continental Europe, the Netherlands has the highest number of SIBs, although with only three (all in the area of employment policy) this number is still low compared to the Anglo-American world.<sup>61</sup> The first was launched in December 2013 in Rotterdam to combat youth unemployment. It involved Dutch bank ABN AMRO and the Start Foundation as investors, which together committed €680,000. The maximum return is capped at 12 per cent, but outcomes are not yet clear enough to gauge how much will be paid out. Two more SIBs have since been launched – one in Utrecht to the tune of €734,000 involving Rabobank Foundation, and another one in Rotterdam involving Deloitte and others – and more are reportedly in the pipeline in other cities.

ABN AMRO is clearly interested in expanding the use of SIBs in the Netherlands and in helping to create the necessary tools and infrastructures. They suggest using SIBs in the areas of health care, crime prevention and child protection services and also suggest that the Netherlands should get involved in DIBs.<sup>62</sup>

ABN AMRO has identified size as a particular challenge in the Dutch context.<sup>63</sup> Dutch municipalities are small, therefore it will be difficult for an SIB to reach 'critical mass', i.e. the financial volume necessary to make the cost of setting it up worthwhile. ABN AMRO suggests bundling and centralisation as a potential solution. This may mean bundling SIBs, which would make them more interesting for investors. On the government side, centralisation through the creation of a national SIB repayment fund/agency is proposed.<sup>64</sup> This would address the problem that arises when successful social projects result in savings for more than one government agency and/or to agencies at different levels (municipal, national etc.). Instead of figuring out who pays how much, payouts would come from one central budget. These are just ideas at the moment, but they indicate how SIBs could change in the future.

---

61 ABN AMRO (2015), p. 58.

62 See also <http://www.kit.nl/sed/news/piloting-a-pilot-using-financial-mechanisms-to-deliver-results-in-development/>.

63 ABN AMRO (2013), pp. 10-11.

64 ABN AMRO (2015), p. 66.

## 7 The risks of harnessing private finance

Each of the instruments described above has its own specific features and risks, but there are also more general risks that come with harnessing private finance for public policy goals. Some of these instruments are a very recent phenomena. The following analysis is therefore partly based on past experiences and partly on an *a priori* assessment of risks in plausible scenarios.

### Volatility makes portfolio investment unfit to be a part of sustainable finance

“Capital flows are fickle: anytime, anywhere.” This is the not entirely surprising result of a 2013 IMF working paper that analysed private capital flow patterns for 150 countries from 1980 until 2011 and emphasised the low predictability of capital flows, especially portfolio flows (so-called ‘hot money’).<sup>65</sup> Although the study found that volatility and low predictability are a fact of life for all countries, it also found that, in the case of emerging and developing countries, these flows are strongly driven by the behaviour of *foreign investors*. This leaves those countries more exposed to the ups and downs of financial markets than advanced economies (from where many of these foreign investors originate).

Volatility has shown no sign of abating. In fact, 2015 was a particularly hectic year for developing countries due to a number of events that are upsetting the global economy, such as the drop in commodity prices, the possibility of higher interest rates in the US and concerns about overall economic growth. In 2015, capital outflows, including portfolio capital, have been at their largest since the 2008 financial crisis.<sup>66</sup> In that context, the UN has also warned of the risks of short-term capital flows, especially sudden outflows, and concludes that **“short-term capital flows cannot be regarded as part of sustainable finance”** (p. 90). These are the kind of capital flows that policy-makers increasingly want to harness to finance what are often long-term goals, commitments and projects.

All countries are exposed to capital flow volatility, but it means different things to different countries, and that also applies to attempts to open the financing of infrastructure and development projects to portfolio investors. Developing countries usually do not have deep domestic capital markets. So when infrastructure and other assets are opened to capital market financing, developing countries will have fewer domestic institutional investors waiting to buy these instruments than developed countries and will therefore have to deal with a higher share of foreign portfolio investment – the kind of investment that is prone to vanish when things get rough.

65 J. Bluedorn et al. “Capital Flows are Fickle: Anytime, Anywhere,” IMF Working Paper, 2013, WP/13/183, <https://www.imf.org/external/pubs/ft/wp/2013/wp13183.pdf> (accessed 2 May 2016).

66 UN, World Economic Situation and Prospects 2016, 2016, pp. 18; 83-6.

One must also be wary of the win-win rhetoric that tends to accompany efforts to harness private finance to attain public policy goals. The creation of infrastructure bonds and similar instruments is said to match the long-term financing needs of such projects with institutional investors' need for long-term assets. However, once these assets can be easily traded on secondary markets, there is no guarantee that they will only be held by 'patient' long-term investors. They will also attract the attention of asset managers with shorter-term and/or more speculative investment strategies, such as hedge funds or private equity funds. In fact, the allegedly long-term institutional investors themselves tend to use these funds as intermediaries to invest in infrastructure assets.<sup>67</sup> In other words, even long-term money is invested short-term because of the peculiar strategy of the intermediary.

Finally, the inherent unreliability of this source of financing can create uncertainty about refinancing costs if bonds need to be rolled over, i.e. when existing debt is to be paid with new debt. In the current global economic situation, a rise in financing costs is a plausible scenario that would cause substantial problems for developing countries.<sup>68</sup>

## Pro-cyclicity: increasing exposure to the ups and downs of the economy

Private portfolio flows are pro-cyclical: they reinforce economic trends rather than mitigating them.<sup>69</sup> Relying on them to finance socially and economically important goals and projects exposes the latter to the ups and downs of the economic cycle, whereas public finance is in principle capable of compensating for cyclical funding shortfalls, partly because governments can borrow more easily in economically difficult times (i.e. borrow counter-cyclically).

When instruments to harness private finance involve public guarantees, there may also be a pro-cyclical effect on the public budget because such guarantees are more likely to be triggered in bad economic times. Such times are also bad for the public budget because tax revenues decline and expenditure for social policy or subsidies to the poor goes up, so the payouts related to guarantees make an already bad fiscal situation even worse.<sup>70</sup>

---

67 A. Caliori, "Financing Infrastructure in Financial Markets: Why Civil Society Should Be Alert," 2016, <https://za.boell.org/2016/02/02/financing-infrastructure-financial-markets-why-civil-society-should-be-alert> (accessed 2 May 2016). For more about the tendency of institutional investors not to behave as they are supposed to, see also S. Schmuckler, "Institutional Investors: From Myth to Reality," World Bank Policy Research Talk, 1 June 2015, <http://www.worldbank.org/content/dam/Worldbank/Event/DEC/DECRG-Policy-Research-Talks/Sergio-Schmukler-PRT-Institutional-Investors-1June2015.pdf> and <http://www.worldbank.org/en/news/feature/2015/06/18/institutional-investors-the-unfulfilled-100-trillion-promise> (accessed 04 May 2016).

68 UN (2016), p. 18.

69 F. Broner et al, "Gross capital flows: Dynamics and crises," *Journal of Monetary Economics*, 2013, 60(1), pp. 113-133.

70 A. Caliori (2014), p. 20.

## Additionality: who leverages whom?

Additionality (in a financial sense) means that the private money in a public-private financing arrangement would not have been invested without the public component. If the private actor would have invested anyway, it is arguably the private sector that is 'leveraging' public money, not the other way around, because the public contribution reduces the risks of private investments. It would essentially be an unnecessary subsidy and would reduce value for money for the public.<sup>71</sup>

Harnessing private finance through the above-mentioned instruments is a relatively recent trend, so there is no wealth of experience to judge whether the projects that were and are being financed fulfil the additionality requirement. However, reviews of experiences with public-private financing arrangements in a development context and an audit report of the pilot phase of the EU Project Bond Initiative suggest that results have been mixed.<sup>72</sup> The additionality requirement is sometimes met and sometimes not, without any dominant tendency.

Additionality is another complex issue because it is difficult to define and measure. Moreover, it depends on a number of variables over which government agencies or financing institutions have varying degrees of control. They do have some control over project selection and design, but others are less easily influenced. For example, additionality also depends on the specific country context and the constantly changing economic environment: what would have been necessary to attract private finance yesterday may not be so anymore today because financial market conditions have changed.

To sum up, additionality is achievable, but to be reasonably certain about it, government agencies will have to take great care when selecting projects to be financed and making the arrangements. This further adds to complexity and cost.

## Loss of control

Increased private sector involvement – including the more indirect involvement of portfolio investors – can influence policy by skewing decisions about what gets done and what doesn't. Governments or asset managers must take into account the risk-aversion and return expectations of private investors at project selection stage. Political priorities will have to be balanced with the necessity for projects to be commercially viable, which will in turn influence the choice. This kind of private sector influence over policy is not the result of lobbying or corruption, but an unintended effect of the need

71 O. Reyes, "Critical Issues for Channelling Climate Finance via Private Sector Actors," 2013, [http://cafod.org.uk/content/download/9496/76572/file/Channelling%20Climate%20Finance%20via%20PS%20actors\\_April2013.pdf](http://cafod.org.uk/content/download/9496/76572/file/Channelling%20Climate%20Finance%20via%20PS%20actors_April2013.pdf) (accessed 2 May 2016), p. 5.

72 Y. Arvanitis, "Blending grants and loans for private sector development: The use of grant elements and the AfDB's experience," *Africa Economic Brief*, 2013, 4(2); UKAN, "Leveraging Aid: A literature review on the additionality of using ODA to leverage private investments," 2015, <http://www.ukan.org.uk/wordpress/wp-content/uploads/2015/03/UKAN-Leveraging-Aid-Literature-Review-03.15.pdf> (accessed 2 May 2016); E&Y, "Ad-hoc Audit of the pilot phase of the Europe 2020 Project Bond Initiative," Final Report 3 December 2015, 2015, [http://ec.europa.eu/dgs/economy\\_finance/evaluation/pdf/eval\\_pbi\\_pilot\\_phase\\_en.pdf](http://ec.europa.eu/dgs/economy_finance/evaluation/pdf/eval_pbi_pilot_phase_en.pdf) (accessed 2 May 2016), pp. 23, 56.

to make participation attractive for commercially motivated investors. That does not make it any less problematic from the point of view of those who are supposed to be the ultimate beneficiaries of certain goods, services or projects. (CP3s are a good example because investment decisions are explicitly delegated to a commercial asset manager.)

This can lead to **policy incoherence**. For example, a developing country may decide that upgrading and expanding its water supply network is the most important development goal and that various projects in that area should be financed. A commercial asset manager, on the other hand, may invest in one such project at one time, but in something entirely different next time. Instead of pursuing a coherent development strategy, the asset manager will prioritise projects that are most likely to yield a return. This lack of a coordinated approach reduces effectiveness.

In the case of Impact Bonds, the need to measure outcomes may have the effect of channelling financial resources, and therefore social policy efforts, into areas or projects where such outcomes can be (relatively) easily measured, leaving unmeasurable problems unaddressed.<sup>73</sup>

In the case of infrastructure, there is also the possibility of a fatal insulation of infrastructure investment from political and social demands. To create the predictable revenue streams that project companies and institutional investors demand, infrastructure should be removed as much as possible from political interventions, especially controls on user fees or prices.<sup>74</sup> Such controls are sometimes used by governments to make access to water, energy or transport services affordable for poor citizens, often in reaction to pressure from social movements. Insulation from such pressures will please investors, but sits uneasily with democratic politics.

There is also a geographic dimension to the loss of control. According to Reyes, UK public support for climate finance initiatives reproduces the geographic pattern that is observed in the case of FDI flows: most goes to a handful of 'emerging market economies', while the poorest countries receive only a very small share. Therefore "mechanisms to use public finance for leveraging are highly likely to reproduce the distribution of existing private finance flows".<sup>75</sup> There is no reason to assume that this would be different when ODA is used to 'leverage' private finance.

## Emergence of a new financing regime?

Are we witnessing the emergence of a new financing regime for public policy goals, one that, through its exposure to the whims of portfolio investment flows, will be marked by instability, fiscal risks and loss of political control – with serious consequences for economies and societies? If yes, these risks would affect all countries that shift to the new financing regime, but they would be especially severe for developing countries because they have fewer means to cushion the blows from the in- and outflows of private finance and to insulate their societies from the risks attached to them.

---

73 Princeton University (2014), pp. 17-18.

74 OECD, "Fostering Investment in Infrastructure", 2015.

75 Reyes (2013), p. 5.

## 8 Conclusions

The risks and problems of harnessing private finance to attain public policy goals are manifold and they are highly significant – at least if the initiatives discussed above and similar ones are to be scaled up to a level that allows institutional investors to participate in financing public service provision, infrastructure or development assistance projects on a regular basis.

The following is a list of some of the main risks and challenges:

- ❑ Complex multi-party arrangements lead to a lack of transparency and high transaction costs.
- ❑ Exposure to volatile and pro-cyclical portfolio investment flows creates unpredictability of follow-up finance and financing costs.
- ❑ There is a strong possibility that unnecessary and excessive fiscal risks may be incurred because of a lack of transparency and because governments may be tempted or obliged to entice private sector actors through excessive guarantees and risk transfers.
- ❑ Harnessing private finance means ceding control over project selection and policy goals to financial investors to some degree.
- ❑ Instruments like infrastructure or Impact Bonds need to be standardised and scaled up substantially if they are to attract institutional investors on a regular basis. At the same time, however, there are fundamental economic obstacles to such standardisation and up-scaling. These can perhaps be overcome, but someone will have to bear the initial costs of doing so. This task will almost certainly fall on the public, but the chances of getting good value for its money are not good.

The promises of harnessing private finance – closing the funding gaps in infrastructure provision, development and social policy and reducing the fiscal burden on the public by providing institutional investors with the assets they need to close their funding gap between their obligations to clients and their low-yielding assets – appear lofty and not very realistic in comparison. Careful consideration of the arguments and existing experiences clearly suggests that, **from a public interest perspective, the risks of harnessing private finance to attain public policy goals outweigh the benefits. If policy-makers and governments decide to go ahead regardless, they may find that harnessing private finance is more like riding a tiger!**

If private finance could be attracted on a limited scale and only when needed or welcome, e.g. to supplement public provision or ODA financing when an extraordinary need arises, it would be worth considering. This is providing that deals are structured in a way that ensures fair risk sharing between private and public actors – something that cannot be taken for granted, especially in low-income, low-capacity contexts. However, the scale that is necessary to turn these unconventional instruments

into mainstream financing tools makes this seem unlikely. Therefore the choice seems to be between the following three options/scenarios:

1. Turning public-private financing arrangements into regular financing instruments, with all the costs and risk transfers that would entail, in the hope that one day the private financial sector, especially institutional investors, will provide financing on a continuous basis *without* the public ingredient. This may be possible in the long run, but not without big initial investments from the public sector, the main beneficiaries of which would be private sector providers and financiers, and not without massive changes in the provision of services or projects on the ground that would negatively affect the final users/beneficiaries.
2. Though highly undesirable, it is possible – and not even unlikely – to establish public-private financing as a permanent feature of the public policy financing regime. Not, as in the first scenario, as a self-sustaining form of finance, but a bad compromise between fully public and fully private provision in which private sector actors continuously rely on explicit or implicit public subsidies.
3. Maintain or return to a regime of public provision and development assistance based on ODA. Public procurement would form a legitimate part of this regime in situations where private providers are genuinely more efficient or innovative than public ones. Despite its difficulties, like the risk of corruption, public procurement still is substantially less complex than some of the public-private hybrids currently touted and involves a clearer division of risk. This would require abandoning austerity policies and returning to more progressive taxation to strengthen governments' fiscal capacities.

## 9 Recommendations

### For governments and policy-makers

Whether in developing or developed countries, it is absolutely imperative that governments develop a **strategic approach** to harnessing private finance. Partly because the scale needed to make institutional investors an integral part of the financing regime in one or more areas of public provision (including development assistance) inevitably makes this a sizable and long-term undertaking and would entail significant shifts on many levels. It is not something one can simply try out in a pilot project; it requires serious commitment and resources – or a clear decision not to go down that road at all.

**The best strategy is to opt for a system of public provision/procurement and development assistance based on ODA.** However, if governments still feel that they must harness private finance they should:

- ❑ **Formulate an exit strategy:** Setting up the new financing regime will require considerable initial investment on the part of governments and development banks. However, to reduce fiscal risks the long-term goal must be to reduce financial commitments as much as possible and retain only supervisory and regulatory functions. Where public money is meant to have merely a ‘catalytic’ function, financial commitments that bear more risk than the private sector actors should be phased out entirely. Where ‘leveraging’ of public resources is intended and is demonstrably effective, a public grant or subordinate loan element can be retained, provided that additionality and fair risk-sharing can be guaranteed.
- ❑ **Retain as much control over project selection as possible:** There will have to be some concessions if private finance is to be involved, but these must not go too far, or else the lack of political coordination may make even successful individual projects ineffective on the whole. In the case of development assistance, mechanisms must be in place to ensure that potentially affected communities and municipalities are able to participate during all stages of a project from selection to unwinding.
- ❑ **Include social and environmental safeguards:** All public-private financing schemes must have safeguards to ensure that environmental and social criteria are considered and due diligence is carried out at the selection stage. (A great number of guidelines and framework is now available.)<sup>76</sup>
- ❑ **Transparency and accountability must be safeguarded:** Financing terms and the conditions of guarantees in particular must be disclosed and subjected to public scrutiny at all relevant levels of government during the negotiation process. The names of all companies and intermediaries

---

76 For an overview see SOMO, “Mobilising the financial sector for a sustainable future,” 2015, [http://www.somo.nl/publications-en/Publication\\_4255](http://www.somo.nl/publications-en/Publication_4255).

involved must be made public. Where project selection and supervision are delegated to private intermediaries, mechanisms must exist to hold them accountable.

- **No undue risk transfers to the public:** Where government agencies provide guarantees or other subsidies, they should be restricted as far as possible to a clearly delimited inception phase of a particular financing arrangement or instrument. Where subordinate loans or guarantees are used on a continuous basis in the context of 'leveraging' schemes, the fiscal risks must be fully accounted and provisioned for and must not exceed reasonable amounts (e.g. the amounts commonly put at risk by publicly-owned development and investment banks).
- **Ensure additionality:** Apart from clearly defined criteria, this requires paying attention to shifts in the economic and financial environment and adjusting criteria accordingly. In the case of development assistance, it also means taking country-specific factors into account, such as the degree of development of the domestic financial system.
- **Avoid impact bonds altogether** because of their prohibitive complexity and close-to-zero chance of generating public sector savings as well as attractive and relatively risk-free returns to institutional investors. There is no harm if charitable foundations provide grants to fund social policy interventions, but there is no need for such a complicated instrument.

## For activists

The various initiatives that are trying to harness private finance are mostly at an early stage, therefore there is still time to **campaign for a return to a system of public provision/procurement and development assistance based on ODA**. Among other things, this requires an end to austerity policies. Therefore, it is **vital to make the connection to the demands of the tax justice movement**. We must challenge the presupposition that budget constraints are unalterable and insist on the long-term goal of restoring the fiscal capacity of the state to carry out the necessary investments and interventions by itself and/or public procurement. The public outcry over the role of tax havens and legal tax avoidance by corporations and rich individuals has made it easier to argue for this in public, as has the recent debate on social inequality.

Where governments decide to go down the road of public-private financing, we must insist that the above-mentioned recommendations are followed and **emphasise the need for an exit strategy**. The worst – but not the least likely! – outcome is an ill-defined muddle in which the public continuously shoulders excessive risks for an unforeseeable future.

## **Harnessing private finance to attain public policy goals?**

How governments try to involve the private sector in times of austerity and what risks this entails



This report examines the recent policy trend of trying to get private portfolio investors to contribute funding to projects that have traditionally been considered the responsibility of government. The focus of the report on the attendant risks, especially increased exposure to volatile cross-border portfolio flows. Low- and medium income countries are particularly affected because they are more exposed to the risks that come with increased reliance on portfolio flows than developed countries, but have fewer capacities for coping with them.