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Use of subsidies by Development Finance Institutions in the infrastructure sector

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Key points

- Donor governments support a wide variety of development finance institutions so that they invest in financially viable projects, mobilise additional private investment and move into areas where the private sector prefers not to go.
- In 2005, DFIs invested US$ 7.5 bn in private sector infrastructure projects and provided at least US$ 200 million worth of technical assistance.
- The DFI sector would benefit from more transparency, particularly in the way subsidies are being used.

Development finance institutions (DFIs) play a crucial role in providing higher risk loans, equity positions and risk guarantee instruments in support of private sector investments in developing countries, including in infrastructure (Box 1 lists the principal DFIs covered in this briefing).

DFIs have substantial resources backed by guarantees and capital endowments from governments in developed countries. In 2005, total commitments (as loans, equity, guarantees and debt securities) of the main regional, multi-lateral and bi-lateral DFIs totalled US$ 45 billion. Of this amount, US$21.3 billion went to support the private sector (Chart 1). The combined committed portfolio was US$ 182 billion in 2005.

Over the last fifteen years there has been general underinvestment by the private sector in infrastructure in many developing countries (see e.g. the Commission for Arica report). Total commitments to public-private investments (PPI) in infrastructure in developing countries was US$ 47.8 billion in 2005. Of this, telecommunications accounted for 25% and energy for 29%. Other key sectors include transportation and, to a lesser extent, water supply. Investments have been higher in East Asia, moderate across Latin America as a whole, and low in Africa. Sub Saharan Africa accounted for only 3.8% of total PPI investments in infrastructure in developing countries over 1984-2005. Over the 1990-2002: PPI investment was 0.6% of GDP in Africa compared to 1.7% in LAC. Total DFI commitments to private sector infrastructure were around US$7.5billion in 2005 – or 16% of total PPI investment.

This briefing considers 1) the rationale for the use of subsidies by DFIs in infrastructure; 2) the expressions of subsidies in practice; and 3) key issues for the future use of subsidies for infrastructure with large development effects in high risk countries.

What is the rationale for the use of subsidies by DFIs in infrastructure?

Infrastructure plays an important role in development, but there are large unmet needs. This is because the provision of infrastructure has public good aspects, which tend to lower the incentives for the private sector to provide an optimal level of infrastructure. Infrastructure investments contain substantial risks because of the large upfront capital investments and long payback periods influenced by government policy and practice. Because of such risks, the private sector may hold off investing until more information becomes available that makes the environment less risky. Public involvement can help to correct these risk perceptions, promoting favourable conditions under which private investment takes place and encouraging the provision of a socially optimal amount of infrastructure.

So why use DFIs and why use subsidies? DFIs have a general mandate to provide finance to the private sector for investments that promote development. Infrastructure fits within this remit.

Box 1: Principal DFIs

Bi-lateral DFIs

CDC - UK
DEG - Germany
FMO - The Netherlands
PROPARCO - France
OPIC - USA

Regional DFIs

EBRD - European Bank for Reconstruction and Development
EIB - European Investment Bank
AsDB - Asian Development Bank
IADB - Inter American Development Bank
AfDB - African Development Bank

Multilateral DFIs

IFC - International Finance Corporation
MIGA - Multilateral Investment Guarantee Agency

Overseas Development Institute

The raison d'etre of DFIs is to engage where the market fails to invest sufficiently. DFIs engage particularly in countries with restricted access to domestic and foreign capital markets. They specialise in loans with longer maturities and other financial products which are appropriate for financing long term infrastructure projects. DFIs aim to be catalysts, helping companies implement investment plans. They provide risk mitigation that enables investors to proceed with plans they might otherwise abandon. Further, because of the unique characteristics of DFIs they have a comparative advantage in providing finance that is related to the design and implementation of reforms and capacity-building programmes adopted by governments.

What are the "subsidies" used by DFIs?

We consider the term 'subsidy' in its broadest terms, meaning an explicit or implicit transfer from the public sector (here: shareholder governments in DFIs) to the private sector (here: firms and investment funds operating in developing countries). These transfers result in different conditions available in DFI operations than would be normal practice in the commercial financial sector. Transfers can be aimed at private sector beneficiaries directly (e.g. in the form of interest rate subsidies) or indirectly through its effects on the conditions under which DFIs are allowed to operate (e.g. lower costs of capital because public shareholders do not require commercial rates of return on their investments).

This definition includes a broad spectrum of issues, and goes beyond technical assistance grants in infrastructure to the raison d'etre of DFIs because without some transfer of finance or guarantees, DFIs would not be able to invest in infrastructure as they do at present. There are three main forms of subsidies in the operations of DFIs in practice:

High level of liquidity. Levels of liquidity in DFIs are higher than in commercial banks because of large levels of paid-in stock; additional 'callable' capital; exemptions on dividends and corporation tax (for example, IFC, EBRD, CDC Group, DEG, Proparco and EIB are all exempt from paying tax on profits); cost of borrowing at sub LIBOR due to their institutional AAA credit ratings and implicit state guarantee; and income from trading in borrowings.

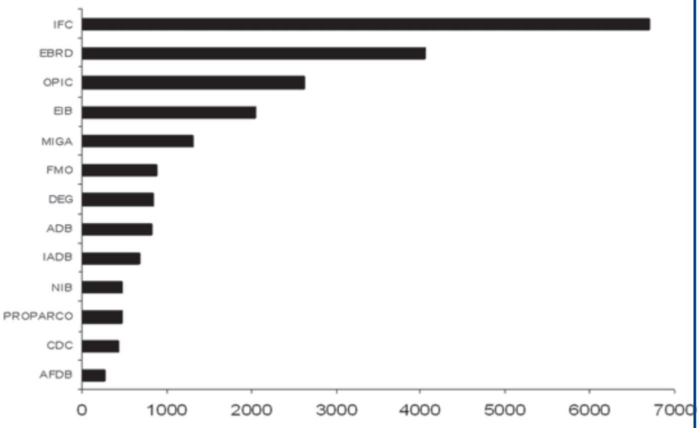
The mandates of DFIs ask them to leverage such liquidity to invest in developing countries. With high growth in developing countries, DFIs can obtain high returns on equity investments and loans will be repaid. Indeed, the DFIs currently experience high levels of income. Total capital (capital stock plus designated and undesignated retained earnings) at the IFC is now close to total commitments of loans, equity and debt securities (see Chart 2), and the institution's capital adequacy ratio has risen from 45% in 2002/3 to 57% for 2006/7. The FMO's capital adequacy has increased from 38.4% in 2000 to 50.5% in 2005. CDC's rate of return has outpaced emerging markets stock market indices.

An ability to access technical assistance funds. The total amount of technical assistance (TA) funds floating inside or around DFIs is impressive. Our quick survey found that at least US$ 200 million is currently spent annually by DFIs on TA activities to support the private (and public) sector in developing private investment projects. Some services are provided for a fee or on a costs sharing basis, while others are in grant form and/or sourced from the DFI's retained earnings. Some TA funds are for specific projects and clients, others for broader, upstream, investment climate or financial reform programmes. We can also distinguish between TA funds under the direct control of (or located in) DFIs, and those TA or grant funds that can be accessed or influenced by DFIs.

To illustrate, the EIB Facility for Euro-Mediterranean Investment and Partnership (FEMIP), financed by the EC, directed €105 million in 2005/6 to help Mediterranean countries create an enabling environment for the development of private enterprise and to support project identification and preparation. Of this around €20 million is for infrastructure. FMO, the Dutch development finance institution manages a €5 to €7 million annual Capacity Development fund, while the IFC designated $1.42 billion to advisory services over 2003/4 to 2006/7.

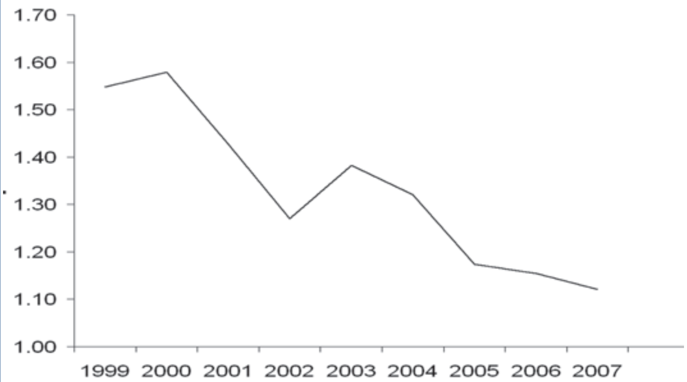
DFIs have tended to leave the provision of grants

Chart 1: Commitments by DFIs to the private sector in 2005



Commitments to developing countries in US$m

Chart 2: Ratio of portfolio commitments to total capital, IFC



Source: IFC. Note: Commitments include loans, equity investments and debt securities capital includes stock plus designated and undesignated retained earnings.

to facilitate investments in infrastructure to domestic governments or donors. Exceptions include the FMO which used to provide grants under ORET, EIB's recently launched EU-Infrastructure fund and the IFC. Over the last three years the IFC has designated a total of US$680 million from retained earnings to its performance based grants (PBG) initiative which contributes to the Global Partnership for Output-based Aid (GPOBA). Within the GPOBA a funding window provides performance-based subsidies to support private investments in basic services including infrastructure. These grants are open to other DFIs, donors, NGOs and the private sector.

Subsidies passed on directly to beneficiaries. The subsidy passed on to the clients of DFIs is mainly in the form of offering partial credit risk guarantees and longer maturing loans than would be possible without their involvement. Whereas a local commercial bank might provide loans for 3-5 years, DFIs can provide loans of up to 10-15 years (and the EIB up to 25 years for infrastructure investments).

Other subsidies passed directly to beneficiaries include: longer grace periods; subordinated debt or other forms of quasi-equity finance characterised by higher risk; equity investments in frontier markets and sectors; and the higher risks that accompany the syndication of loans. There is little evidence of the widespread provision of concessional loans in competition with market norms. In general, DFIs agree interest rates on commercial terms. The lending policies of DFIs reflect their mandate that debt should be priced at a mark-up over the base rate (LIBOR or EURIBOR) which reflects genuine country and project risk, and includes administration costs and fees at market rates. In practice, DFIs appear to apply this principle in broad terms, although there can be differences amongst DFIs at project level.

The use of subsidies by DFIs in infrastructure: looking ahead.

With high levels of liquidity, and continued government backing, it seems sensible to ask questions about the role and direction of DFIs in the future. Most critically: are these institutions bearing an optimal level of risk in their infrastructure operations in developing countries, and in particular, frontier areas; and are the growing range and volume of technical assistance facilities and grant subsidies sufficient, and sufficiently transparent and accessible?

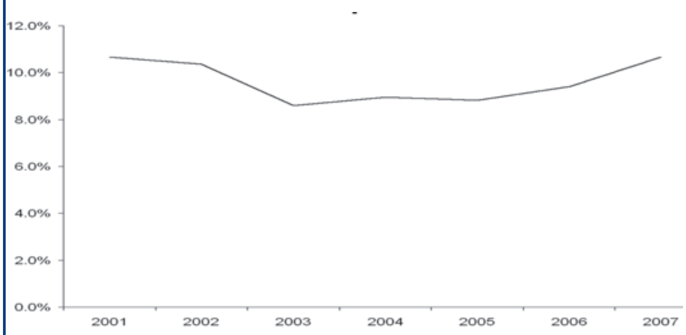
Are DFIs using subsidies to take appropriate risks?

Is it possible that DFIs are receiving mixed messages from their shareholders about what level of risk appetite they should take on? Most DFIs carry a mandate that requires investments to be additional to commercial banks, to direct investments towards poorer, higher risk, countries and sectors, to grow markets and improve the investment climate, to demonstrate that enterprises can develop in economically challenging markets, and to contribute to sustainable development. But the same mandates also require DFIs to mobilise private capital, price products to generate commercial returns and build companies able to attract private capital in the future. Is it really possible to concurrently secure commercial rates of return, mobilise additional private investment and move into areas where the private sector prefers not to go?

The optimal level of risk implies balancing the cost of managing elevated levels of risk (e.g. loss provisions on loans, guarantees and equity impairment revaluations etc.), with the need to maintain liquidity sufficient to ensure stable and high institutional credit ratings, achieve low costs of borrowing, and generate surplus earnings to support designations to technical assistance and grants. Past experiences might suggest whether DFIs are operating at this optimum, for example by looking at what happened during the Asian financial crisis of the late 1990s (see example from EBRD below). During this period DFI portfolios were riskier, loan losses higher and returns lower than they are at present, but is highly unlikely to have adversely affected institutional credit ratings because of state backing. The EBRD argues it is able to withstand the impact of a major shock 3.5 times the size of the financial crisis of 1998, without a need to call capital, although the accumulated reserves would largely be consumed.

A number of financial indicators suggest that DFIs take on less risk. Capital adequacy ratios are increasing, bad loan reserves are decreasing and portfolio shares in Africa are not constant. At the IFC, loan loss reserves fell from 21.9% of the total loan portfolio in 2002 to 8.3% in 2006, and EBRD's from 12% in 1999 to 2% currently. Such falls may indicate better risk management, but also scope for taking on additional risk. With regard to equity investments, beyond the choice of country or possibly sector, fund managers are currently given incentives to apply risk-averse investment criteria which preclude taking positions in high-risk activities with potentially high economic rates of return including in infrastructure in low-income areas. The share of sub-Saharan Africa in IFC's portfolio was only 10.7% in both 2001 and 2007 (chart 3).

Chart 3: Share of IFC's portfolio in Africa



Source: IFC annual reports 2001-2007

Staff remuneration policies also affect the level of risk appetite. For example, the IFC has introduced a remuneration process that links salary awards not only to deal volumes but also to the development impact of past investment decisions. This could mean financially more risky deals, but economically more beneficial deals. An evaluation report by FMO finds that, in practice, projects with a greater impact on development are associated with higher rates of return. The DEG rewards projects with good development ratings.

It would be unwise however to discuss the possibility that DFIs might deploy their liquidity to take on more risk without mentioning the current concerns over access to credit in the wider international financial markets. Although DFIs are less directly affected by the current 'credit crunch' (with mainly fixed rate loans in their infrastructure portfolio), retaining higher levels of liquidity could enable DFIs to take on investments if commercial lenders and equity holders elect to withdraw their assets. In essence, the willingness of DFIs to be, not only the 'first to enter' a market, but also the 'last to leave' should not be underestimated because it reduces the problems caused by herding behaviour of private capital flows.

Are subsidies used in a transparent way?

Given the broad definition of subsidies used here, there are different aspects to consider under transparency.

The DFI system as a whole. Given that DFIs operate on the basis of state "subsidies" (guarantees, commitments or capital replenishments), it is surprising that there is so little attention to this sector. For example, few realise the rather large commitments by the DFIs and the contribution this makes to development. Comprehensive data on DFIs are not reported separately in the main development finance publications.

Technical Assistance. While it is possible to obtain an overview of the advisory services and other technical assistance funds, it is surprising that there has so far been no central data gathering exercise that would collect data on all DFIs' TA support for the private sector. Transparency is needed over the full range of TA funds available, what each is for, the eligibility criteria for access, whether they are 'tied', and what effects they have. The very exercise of gathering this data would also be helpful in avoiding the impression that such funds might be used to attract future borrowers in competition with other DFIs or with commercial financial institutions. It may also help DFIs in their ability to manage and deliver TA funds effectively.

Deal Terms. Within the bounds of commercial confidentiality, greater transparency may also be beneficial if DFI's were to disclose the terms of past deals. More transparency in this area may help move away from a perception that DFIs could be engaged in competing with each other and/or with the commercial sector over interest rates.

Grant Co-financing. Given the need for financing infrastructure in frontier markets where financial rates of returns are lower, with a lack of bankable projects, coupled with the fact that DFIs need to price loans at commercial rates of return, there is an increasingly important role for combining aid and DFI finance, i.e. for grant co-financing, to promote projects to become bankable by addressing firm-specific or sector-wide constraints. Although certain DFI-managed grant facilities, such as the GPOBA have clear eligibility criteria, there could be more transparency in how DFIs in general manage or access grants for co-financing that involve the public sector or donors. For example, there is a need for DFIs to explain their involvement in advising on the levels of subsidy on the one hand, and participating as a financier in the non-subsidy portion of the same investment on the other.

Conclusions

A joint review by DFIs and their shareholders of DFI mandates, operational policies and risk instruments could be timely. This might focus on the suitability of mandates in encouraging risk-taking in frontier and infrastructure markets, and on ways in which DFIs interpret their multiple, and possibly competing, aims around additionality, private capital mobilisation, investment climate and infrastructure provision.

Liquidity across DFIs is certainly high at present; and, although precise information about them is not strong, technical assistance funds for project development and the enabling environment are available in growing abundance. What is less obvious is what are the constraints to doing more deals in frontier markets? It is not clear a priori whether this is a lack of 'bankable' projects, a lack of TA, access to the right type of grant co-financing, or simply a lack of staff time to assess risky deals that may have a low chance of going ahead. It could be worth examining whether support for more investment officers aimed at frontier markets and with experience in grant co-financing - coupled with improvements in the design of technical assistance facilities - might be an effective way ahead for finance in infrastructure projects in poorer countries.

Finally, as DFI and ODA resources are increasingly mixed, it is important to draw up transparent guidelines about how each part can work with the other, and to emphasise the relative advantages of each.

For references, see Velde, D.W. te and M. Warner (2007), Use of Subsidies by Development Finance Institutions in the Infrastructure Sector, ODI working paper 283, http://www.odi.org.uk/publications/working_papers/WP283.pdf

Project information

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