GDN's Next Horizons Essay Contest 2014*

THE FUTURE OF DEVELOPMENT ASSISTANCE

Supported by the Bill and Melinda Gates Foundation

Winning Entry

"PRIVATE SECTOR FUNDING FOR DEVELOPMENT – WHO WILL LEAD THE WAY?"

Abstract

Financing the development of projects spawned by the Millennium Development Goals remains a significant challenge. Now that the focus has shifted to the Sustainable Development Goals, the funding solutions need to be modified accordingly. So long as a project is wholly charitable in nature, the funding solutions remain one-dimensional – only grant funding can be relied upon. Commercial lenders steer clear. However, a shift to sustainable projects implies some form of recognizable business model, together with predictable cashflows. This creates the opportunity to source funding from the banking sector rather than the donor community. There are inherent risks in doing so; projects with a mix of social and commercial elements often come unstuck when seeking bank funding as commercial lenders are not set up to lend against social objectives. This paper explores a practical solution to leverage bank funding for sustainable projects. Using a case study approach, this paper identifies a number of principles for a new development funding model – the 'Social Project Finance Model'. Three key principles (and a co-ordinated approach to their application) form the crux of the proposed Social Project Finance Model:

- The identification of elements of a project that can attract commercial funding.
- The development of a sustainable first phase (with a 'roll-out plan' for the remainder of the project) with secured funding for this phase rather than for the whole project.
- The pursuit of 'socially-friendly' financial instruments. These comply in form with known market instruments but are adapted to replace the stringent commercial terms with returns or outcomes that are aligned with the social objectives of the project.

This paper discusses the practicality of implementing a Social Project Finance Model and makes a number of recommendations for turning it into a reality.

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**The GDN Next Horizon Essay Contest was launched globally by the Global Development Network (GDN) in 2014, with the support of the Bill & Melinda Gates Foundation. The contest invited contributions related to the future of development assistance to inform the ongoing discourse on development assistance with fresh thinking, and revamp policy debates with new voices. This essay is one of 13 winning entries selected by a high-profile Jury of aid policy makers, experts and practitioners chaired by Nancy Birdsall.*

The finance for development challenge

The United Nations has formulated 17 Sustainable Development Goals (SDGs) – adopted by the United Nations Sustainable Development Summit in September 2015.[1] These will drive the scope and types of social projects[1] pursued by governments, policymakers, funders and other stakeholders through to 2030.

In July 2015, the Addis Ababa Conference on Financing for Development produced a comprehensive written report[2] on the funding challenges to meet Sustainable Development Goals. It was clearly based on the proposed SDGs which the United Nations expected to finalize during their September conference. An extract from the report states that: "Solutions can be found, including through strengthening public policies, regulatory frameworks and finance at all levels, unlocking the transformative potential of people and the private sector and incentivizing changes in financing." (United Nations, 2015, p. 5)

The scale of funding required is vast. The Guardian newspaper in the United Kingdom, commenting on the Addis Ababa conference,[3] stated that: "Addis is about moving from billions in financing commitments to trillions," and that, "According to UN estimates, for the new goals to be met will require as much as US$ 11.5 trillion a year, US$ 172.5 trillion over the 15-year timeframe." (Anderson and Chonghaile, 2015)

The Financing for Development report deals with a variety of funding sources – with an important emphasis on domestic funding whereby countries would be encouraged to increase their own tax collections. As expected, the role of international aid organizations features prominently. On the lending side the Multilateral Development Banks are urged to increase the scope of their funding initiatives. Importantly, the report openly acknowledges the need for private sector funders to become part of the solution. Private sector participation is the area of focus of this paper.

The Financing for Development report makes bold statements about what governments and state supported bodies need to do, but when it comes to funding, these are watered down. The Multilateral Development Banks are urged to extend the scope of their efforts in a number of ways but private sector funders are 'invited' to become part of the solution – and therein lies the challenge. Without one or more key stakeholders taking on a driving role in pursuing private sector participation, there is no chance of achieving meaningful private sector funding participation.

Set out below are explanations and examples of the problems for private sector funding of social projects with recommendations on how solutions can be pursued. This should inform a much needed debate about how efforts can be made, and who will make them, to attract private sector funding.

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[1] For clarification purposes social projects can refer to any of the projects that will be pursued in delivering on the 17 SDG's.

Difficulties dealing with development funding from the private sector

The most obvious problem stems from the over-riding profit motive of private sector funders compared to the social outcomes which governments, aid agencies and even the Multilateral Development Banks pursue.

If private sector funding forms some part of the total project funding solution, this will involve multiple stakeholders contributing to the overall solution. The relationship between these stakeholders, who takes the initiative, who holds the balance of power and who drives the communication between them, needs to be determined.

Private sector banks are driven by their focus on financial products and specific projects – they do not deal in the macro-economic environment. The SDGs are broad statements that, therefore, need to be broken down into distinct projects if any meaningful discussion with private sector funders is to take place. For example, Sustainable Development Goal 11 (with a selection of three sub-points) reads as follows:

> Make cities and human settlements inclusive, safe, resilient and sustainable
>
> 1. By 2030, ensure access for all to adequate, safe and affordable housing and basic services and upgrade slums
> 2. By 2030, enhance inclusive and sustainable urbanization and capacity for participatory, integrated and sustainable human settlement planning and management in all countries
> 3. Support least developed countries, including through financial and technical assistance, in building sustainable and resilient buildings utilizing local materials

It has been suggested that SDG 11 is an appropriate area for private sector funding and involvement. Indeed, it is doubtful that the 2030 goal could be achieved without it. In every developed country building loans and mortgages are an integral part of the funding landscape for housing and financial instruments have been developed incorporating both flexibility and sophistication. However, applying a similar housing solution in a Least Developed Country (LDC) in Africa, for example, would be problematic as funding solutions are not easily transferable between jurisdictions.

Inevitably, a key problem lies in the absence of long-term financial assets that are a ready feature of developed countries with well-established insurance and pension markets. Other key problems include the absence of a registry system to record home ownership and registration of security as required in a market reliant on mortgage security. It is, therefore, unrealistic to ask private sector banks to drive a solution for mortgages for one of these LDCs. They are much more likely to be attracted by opportunities that would allow them to implement a standard product that they are already familiar with.

Now, let us imagine that we had access to a task team with varied skills and aid resources. The policymakers in the team (from a developed country) would engage with the appropriate government officials in the target country to explain and suggest an enabling

legislative environment; experienced property lawyers deployed to the team would assist in the drafting of the relevant laws required; and a project could be established to source the professionals (from land surveyors to database specialists) to institute a land registration system – funded by one of the aid agencies (just as the United States did for Egypt some ten years ago). From the banking sector, analysts could be deployed to measure disposable income statistics in the target market and other factors affecting credit worthiness. This type of information is vital at the outset to balance the level of affordability of mortgages with the cost of housing to be constructed.

The question (for which there is no immediate answer) is which of the stakeholders in the public sector would be willing to champion such a solution. Results need to be measured based on achieving all the pre-requisites for private sector bank participation.

If, and when, the enabling environment for private sector bank participation is established across a number of the SDGs, attention needs to turn to how private sector funding can be deployed for social projects. This essay sets out ideas for a 'Social Project Finance Model', describing how the model works and citing an example of a property development project on which the ideas were based (detailed in the following section)

Importantly, the project was located in a township on the outskirts of Cape Town in South Africa, where a large percentage of the city's urban poor are housed. It is a particularly relevant example of private sector bank participation, where the enabling environment factors (for example, an effective land registry and reliable credit information on borrowers) already exist.

Pursuing private sector funding for a developmental social project – Lessons Learned

The idea for the Social Project Finance Model evolved from experience of working on project funding proposals submitted to a commercial investment bank. The proposals related to infrastructure and housing for low-income communities in South Africa. Perhaps like many business ideas, an exposure to a variety of failures first prompted the quest for a new approach.

Most proposals did not make it to the credit committee evaluation stage and those that did were all turned down. It was noticeable that the main emphasis of the project proposals was on their positive social objectives. Yet, a commercial bank's credit committee simply does not approve commercial funding on anything other than its normal commercial criteria. There is no room for sentiment.

One glimmer of hope emerged for those projects which had more than one funder. Working on certain projects with development financial institutions such as the International Finance Corporation (IFC) and the FMO (the Dutch Development Bank), it was apparent that their appetite for risk was greater when adopting a co-financing approach between the development and commercial banks. This made it possible to fund a project that neither institution would have funded on their own.

The principle quickly expanded into three or more funding layers. Certain projects were eligible for sponsor grants (initial sponsors were local authorities and large employers – such as a mining company for a rural development project). In some cases, projects attracted government-related subsidies. A few projects were able to proceed with a combination of these features, but solutions were unique to each project and, therefore, not replicable. The bank then decided to focus only on sustainable and replicable projects.

For social projects, it is therefore important to first establish which elements, or portions of elements, are 'bankable' – bankable refers to the ability to attract commercial funding on regular commercial funding terms. Determining the types of layered funding is the first key element of the Social Project Finance Model.

The second important element which emerged, largely by trial-and-error, was the importance of restructuring projects to ensure that the first phase could be rolled-out during the remainder of the project. Exactly how much to incorporate into the first phase was initially only guess work. After a while certain principles emerged: There had to be sufficient scale to provide a level of sustainability – for example, a school cannot operate with only one classroom; but, at the same time, it does not have to accommodate 500 pupils in the first phase. There also had to be some element of commercial funding available for the elements included in the first phase; they could not be reliant on grant funding alone.

The first phase had to incorporate certain elements to allow for the successful roll-out of the project in subsequent phases. Such issues typically included:

- regulatory aspects
- rights to land or other assets
- an approved institutional framework for stakeholders
- incorporation of the operating entities – the capacity to conclude legal contracts and hire staff or subcontractors
- finalization of the key legal contracts, detailing prerequisite conditions

The first project to be approved was the Khayelitsha Central Business District Integrated Property Project. This was located in a township on the outskirts of Cape Town, South Africa, that occupies some 20 per cent of the municipal area but houses nearly 80 per cent of the municipal population. The project included the development of housing, retail shops, a gas station, a bus/taxi rank, a sports field, a swimming pool and civic services buildings. The funding required totalled some US$ 100 million.

The beneficiaries were lower-income community members rather than the very poor – those in employment whose family income levels were around US$ 35 per day (approximately US$ 1,000 per month) and with at least two income earners – sometimes a third, when a parent with a small pension formed part of a household. Commercial banks were approached to take up all or part of the US$ 100 million funding. Despite substantial

efforts during the following nine months no commercial funding was secured – even from a combination of different development and commercial banks.

The first phase was re-planned with the following components: a retail center, a gas station, nine houses (to reflect the variety and quality of the proposed housing developments), the taxi rank and some of the infrastructure (road access and access to the nearby railway station). The first phase was valued at US$ 20 million – 20 per cent of the original proposal. US$ 15 million of commercial funding was secured (linked largely to the retail shop element), reducing the grant funding to US$ 5 million.

The power of leveraging aid funding through phasing is evident. The ratio of lending to grant funding (4:1) for the Khayelitsha project is somewhat exceptional for a social project, but even with more modest leveraging factors, the principle of aid funding being an enabler of additional funding rather than the 'total' funding solution is clear. In addition, the first phase set out the components required to guide the roll-out of the remainder of the project, along with the key contracts for securing assets and management service agreements. In short, the initial project capacity was established.

While the example relates to housing, the development funding challenges for 'lower-income' communities exist across other industries and project types and are universal to developing countries. These include, by way of example, urban agriculture, solar energy, basic insurance and financial services.

A review of the diversity of social projects will determine the wider range of financial instruments that are being used or which can be applied. While commercial banks focus on loan instruments, there are, for example, a variety of equity participation instruments from numerous private equity funds. In banking terms, equity funding is invariably the most expensive funding option as it entails the highest rate of return in recognition of the greater risk borne by the investor. In terms of social projects, equity funding often refers to grant funding – at no cost to the project. In this case, it is referred to as equity because of the fact that it is often contributed by way of shareholder equity or shareholder loans. This illustrates the basic principle for developing a funding solution when it comes to financial instruments – start with the form of financial instruments already commonly found in the commercial market.

Two examples will further highlight these principles which are incorporated into the 'Social Project Finance Model'. The first relates to a European development financial institution that provided funding for the re-construction of housing destroyed during the conflict in Kosovo. At the last minute the funding was changed from a pure grant to a loan instrument – albeit without interest or the usual demanding terms of a commercial loan. The institution's head of credit explained how, contrary to their expectations, 100 per cent of the loan was repaid, and all within three years: Home 'owners' were able to access standard mortgage finance once their homes were rebuilt and the incentive to gain full ownership encouraged them to repay the reconstruction loans.

This example highlights an important underlying principle: Restructuring at least part of grant aid from a 'hand-out' to a 'hand-up' approach can extend the impact of development aid funding significantly. If a project is successfully implemented, further use can be made, at least in part, of the grant capital. These repayments could be re-used during the expansion or roll-out of the remainder of the project.

The second principle comes from examples of financial instruments such as Development Impact Bonds[4] or Social Impact Bonds.[5] These financial instruments are growing in popularity in the world of development projects. An explanation of this new form of instrument is needed to properly identify the principle incorporated into the proposed development aid funding solution.

Social Impact Bonds were first used in the United Kingdom (for the Prisons Authority) but have since spread to North America and Australia. These instruments have a variety of names – for example, in the US the initiative is often referred to as the Pay for Success concept[6] – but essentially these instruments have the same characteristics. Non-government investors (including big donors) provide the initial investment capital for a project on the principle that the loan will only be repaid if a particular social objective is achieved. So, for example, in a youth job creation project, the initial capital to set up operations and to provide training for job-seekers will only be repaid if the program places a given number of youths in jobs. Failure of the program would result in a financial loss for the program investors rather than a government body. On the other hand, if the program succeeds, the State will repay the loan. However, this may only be a fraction of the cost of unemployment benefit it would otherwise have to pay out.

So, while this is still a form of loan, the conventional clauses dealing with interest payments are replaced by different measures of repayments, conditional upon the achievement of particular social objectives. Other conventional clauses in a loan agreement can also be removed or simplified. For example, conditions related to the provision of collateral security for the loan may not be needed at all if repayments are made entirely contingent on future performance.

The key component of this proposal relating to financial instruments is not a focus on any particular financial instrument or the development of new ones but an analysis of the numerous existing financial instruments and, in particular, clauses that promote social objectives. These financial instruments include bonds, debenture, equity instruments, loans, installment sale and lease agreements, among others.

For example, for rental contracts, there is flexibility in structuring the profile of rent payments with grace periods and stepped payment profiles. The innovative use of the so-called 'rent-to-buy' contract has been applied in social housing. This is, in fact, a combination of two separate legal concepts - an 'option-to-purchase' agreement at a pre-determined price, combined within a standard rental contract. The spin-off benefits for a social housing project may include a dramatic reduction in rent defaults and a lower maintenance cost for housing units. It would seem that the incentive to enjoy the benefits

of ownership and the value created for the occupant, influences the behavior of tenants, encouraging them to act as owners from the outset.

More recent success stories of development projects make good use of existing business models, suitably adapted for the lower-income target market. For example, the Bridge International Academies' concept of an Academy-in-a-Box, has successfully adopted a standard franchise model.[7] The curriculum and operational processes, including management support, has been centrally determined so that each separate 'school' does not have to re-invent the wheel but simply uses the existing material. This has meant that school fees are a fraction of those for stand-alone school models.

Similarly, the Living Goods network marketing approach[8] - which unashamedly adopted the Avon sales approach - relies on incentivized 'agents' providing health education and building a customer base without the need to employ a costly sales force or fund a large advertising campaign.

These examples provide evidence of the effectiveness of building solutions around known business models but customizing them to serve the needs of projects with a social focus. This principle can be embodied in 'socially-friendly' financial instruments where the legal form is retained but the onerous commercial terms are replaced by 'socially-friendly' clauses.

This paper proposes that incorporating the principles explained above in a co-ordinated fashion can dramatically improve the reach and impact of development finance. This will also enable projects to secure match funding from commercial institutions. This co-ordinated approach provides the structure to the 'Social Project Finance Model'.

IMPLEMENTING THE SOCIAL PROJECT FINANCE MODEL

Market research would indicate that the ideas proposed in this report are widely used but are not combined or pursued in a structured way. This report proposes that only through a structured 'model' approach can they prove to be an effective solution for the world of development aid funding.

It is important to incorporate the key building blocks in a particular sequence:

- Identify the 'bankable elements' of the project.
- Develop a sustainable first phase – with a 'roll-out plan' for the remainder of the project.
- Incorporate 'socially-friendly' financial instruments through which aid-related funding can be secured.

Identifying the 'bankable elements' of the project are a must at the outset. The fact is that a number of development projects are wholly charitable in nature. There is no point in pursuing the funding solutions proposed in this report for such projects. Identifying more carefully which elements are bankable will allow project sponsors to target the correct financial institutions. There are, for example, significant differences between funders of

infrastructure and funders dealing with consumer finance. Any approaches to funders need to highlight the appropriate commercial elements.

For those projects that meet the first principle, the next stage involves developing a sustainable first phase. With the incorporation of commercial funding elements, project sponsors need to understand the importance of minimizing or mitigating project risk for commercial funders. It is much easier to get additional funding, even from the same lender, once a project can demonstrate it can deliver on its objectives. It is much more difficult to secure funding for the whole project at the outset as commercial lenders are generally not prepared to take on that level of risk. In addition, the scaling back of the grant aid element for the first phase often simplifies access to donor funds or grant aid support.

Once the first phase has been determined and a level of commercial funding identified, attention can be given to pursuing 'socially-friendly' financial instruments for securing funding. In addition, more attention needs to be given to structuring pure grant funding within commercial funding agreements. This will allow successful projects to further expand or kick-start other social projects.

The practicality of implementing a Social Project Finance Model

Can the proposed Social Project Finance Model work in practice?

There are undoubted challenges. The first relates to securing the required set of skills. Project finance skills are abundant – but simply not available to social projects. Bank employees operate within the constraints of the commercial objectives of their employers. They cannot be expected to work on a charitable basis. When it comes to project developers with relevant experience in delivering social projects, they often lack the knowledge for working with commercial funding.

The problem is overcome if a team approach is adopted. What is needed at the outset is a small team to give effect to the Social Project Finance Model. To do so will require the support of a sponsor for the start-up team.

The start-up team would be limited in size, comprising both those with social project development experience and project finance experience. Such a team would need to be paid fair remuneration. A bridge funding facility would need to be established – but with plans for repaying the loan. The projects the start-up team selects must include plans for a full recovery of the cost of such a team within the project funding budget.

CONCLUSION

Private Sector Funding for development projects requires the active participation of public sector representatives who can stimulate debate among relevant stakeholders and set the agenda for encouraging private sector banks to participate in the Funding for Development challenges.

Initially, effort needs to be made on structuring the enabling environment to foster the interest of private sector banks in a new area for them – social projects. Incorporating private sector funding within social projects needs to be structured to accommodate the requirements of private sector banks. The first step should be to develop social projects with bankable components and plan a smaller, sustainable first phase, with a view to expanding the project at a later stage. Thereafter, the identification of 'socially-friendly' financial instruments that are responsive to social objectives would provide a development finance solution. Adopting a structured and co-ordinated approach, would allow for a new development funding model to emerge.

A suitable start-up team sponsor, willing to fund and establish a team to give effect to the Social Project Finance Model, could make the project viable and cost effective.

Following implementation, measurable targets for implementing the model could be set, enabling projects to more effectively leverage development aid. The proposed Social Project Finance Model seeks to develop sustainable funding solutions – built on existing funding mechanisms. The results should ensure that many valuable social projects which would otherwise not get off the ground can now become a reality.

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