

How can we optimize the use of public funds to encourage private investments?

Round table // Social business



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Executive summary

The combination of public subsidies and private investment is often an essential pre-requisite for maximizing the social impact of a project and ensuring its financial durability. This roundtable concentrated on public-private partnerships and discussed the question of the efficiency of public support to private businesses.

Funds dedicated to public development aid are getting rarer. This is why public development aid agencies must generate systems where the leverage provided by the available public funding would attract private funds that may invest in the South if there is liquidity and profitability. Different types of systems can be developed towards this aim: advocacy and research; encouraging the establishment of an adequate regulation; warranties; involvement in the riskiest projects and absorption of initial losses; acting as an investor, in patient capital, shareholdings or debt.

These systems are aimed at giving confidence to private investors. However, project leaders and entrepreneurs are experiencing difficulties in raising funds. This is related to the fact that project leaders have difficulty completing applications for funding and that investors are not very familiar with the geographical areas in question. Migrants can be a source of clients and lenders at the same time, provided that money transfers are aimed at developing economic activity and not at consumption.

Synthesis

Public development assistance is a strategic issue, but is not a major priority for Northern countries, who are confronted with the urgency of stimulating economic activity while tackling the debt issue. Therefore, public money invested in development aid is getting rarer. However, at the same time, there is considerable potential related to private funds that could be made available for development. A greater part of these sums could be invested in the South provided that there is liquidity and security. This roundtable aimed to evaluate the systems by which the available public funding can leverage private resources.

Marc Bichler is the Chairman of **e-MFP** and the Director for Cooperation at the **Ministry of Foreign Affairs in Luxembourg**. He is a specialist in inclusive finance, which aims to develop economic activities in the South amongst poor populations. He explained which indirect and direct mechanisms could be used to mobilize private funds.

Indirect initiatives could involve advocacy towards international organizations as well as governments and regulators in third world countries, in favor of microfinance, for example. A third of the funds invested in microfinance worldwide (3 billion dollars) are registered in Luxembourg. This is three times as much as Luxembourg's contribution to development aid. Moreover, we must keep in mind that Luxembourg's commitments with regards to development aid have been reached, which is not the case for the majority of other developed countries. However, it is still necessary to develop alternative resources.

Talking about microfinance, one needs to emphasize that this is a way of eradicating poverty by using sustainable finance. It is important to be aware that some investors are willing to accept a decrease in their financial revenue in order to be able to claim that they are responsible investors. In this regard, microfinance is keeping its promise of sustainability as it is mutually beneficial for the 'micro-client' and for the investor. Conditions that need to be met in order to ensure the development of microfinance are the same as the ones all traditional financial transactions have to meet. Trust, capability, management skills and transparency are key to manage money in a responsible way. Finally, the aforementioned sine qua non condition is the disposition of Northern investors to decrease their financial revenue in order to act in a socially responsible way. A well implemented regulation is of course of paramount importance for the protection of clients and for the credibility of the industry. These are the messages that public players must communicate to private players.

Aside from those indirect ways, there are also direct courses of action. Public cash flows are naturally more flexible, whether these funds are raised by donation or by investment, because they are less geared towards financial return. Public funds can thus be invested over a longer period of time or can serve as collaterals and be used as leverage. This way, wavering investors can be encouraged to invest. Public funds can also absorb the risk of initial losses. This is the case in Luxembourg for a commercial fund, whose risk of initial loss is absorbed by a ministry with a target sum of 25 million Euros.

Therefore, even if Official Development Assistance (ODA) will never be sufficient, neither in the North nor in the South, it is still of paramount importance to instill confidence in private investors, who are motivated by the ideas of mutual benefit and sustainable development. ODA can also be efficiently spent by conducting research in the field of microfinance in order to create solid databases. The role of a public donor can also involve backing the fact that, although everyone is not an entrepreneur, everyone has needs in terms of micro-savings. Micro-savings represent a significant source of capital in times of crisis.

Perrine Pouget, from the **EIB**, reminded us that the Bank is made up of public capital whose shareholders are the 27 European member states. The EIB portfolio's assets are located in Europe as well as outside of Europe, due to different mandates. For example, the Cotonou mandate manages the African, Pacific, and Caribbean states. The EIB's intervention in microfinance, at the moment, mainly relies on their involvement in microfinance funds. The Bank plays a financial role as well as a technical assistance role, worth 200 million Euros. The Bank's contribution consists in accepting more risk than private funds in order to encourage private investment.

Therefore, the EIB participates, along with PROPARCO, in first generation funds with public and private developers who wish, for example, to target a new niche in the market or newly served areas. The EIB works towards the improvement of the features and conditions of the funds whilst optimizing legal and financial factors and ensuring that they adhere to good practices. Once developers have made their propositions, the EIB provides technical assistance in order to ensure that the funds are in line with international standards. The EIB also deals with second generation funds with management companies who have less difficulty in attracting private funds. These companies have acquired experience and thus stand out to private investors.

The EIB offers various advantages, proposing investments in patient capital, made especially in a counter-cyclical way with respect to the rest of the financial market, and occasionally in countries that are affected by conflicts or catastrophes. For instance, the EIB granted Haiti long term loans in local currency, something other lenders were not willing to do given the disaster. The EIB also provides technical assistance grants in order to improve the quality of operations and, as a result, the profitability of the project.

Laurent Demey, associate managing director at **PROPARCO**, explained that PROPARCO is a subsidiary of the AFD (French development agency) that offers financing in line with market conditions. PROPARCO's activities work as financial leverage. Out of a 2.5 billion Euros portfolio, 300 million Euros come from public funds and the rest is private. These sums are invested in projects in the South. PROPARCO's capital generates return on equity because their clients are private and profit-driven. By the same token, public funds are not considered donations and must exert a leverage effect. In the field, PROPARCO's portfolio is invested in long term capital

and debt in private projects worth up to 1 billion Euros per year, split into 200 million Euros in equity and 800 million Euros in long-term debt.

Areas in which PROPARCO is operational include:

- Industrial agriculture, with the goal of creating jobs
- Local development
- The financial, microfinance and banking sectors at large, given that the problem in a lot of African countries is the under-development of the local banking system (in Burkina and the DRC less than 10% of the population have access to banking services). This area of PROPARCO's operations requires more than 50% of the funds available.
- Investments in microfinance investment funds and local small and medium-sized businesses.

PROPARCO exerts a leverage effect by investing along with private investors and private banks and providing the financial resources that the latter do not have at their disposal. These unavailable financial resources include long term debt or equity, which are essential to attract local banks towards co-investment.

- Example 1: The great dam in Bujagali, Uganda, was created on the Aga Khan's initiative, and allowed to double the electricity production. No private investor was eager to take a risk over 10 or 20 years in Uganda. However, the EIB and PROPARCO injected their funds to make up the necessary pool of capital to build this dam.
- Example 2: Alamana is one of the main MFIs in Morocco. The AFD really supported this sector, which has now achieved the level of maturity necessary to raise local resources, in spite of a remaining lack of equity funds. PROPARCO invested some capital in equity, and each euro that PROPARCO contributed allowed Alamana to lever 7. In this respect, development assistance has worked hand in hand with different operators such as the State, public funds, and commercial banks.
- Example 3: PROPARCO's intervention in the field of cellular telecommunication in Afghanistan and Haiti constitutes another interesting example. Telecommunication is one of the rare sectors where private operators can run businesses in this kind of region, and therefore

become big investors and big employers. However, there are few people prepared to lend money to this type of businesses, and this is why PROPARCO and the Asian Development Bank got involved.

PROPARCO runs technical areas of businesses and grants donations to cover for initial losses, which might seem strange, given that the project can thus generate seemingly undeserved profit. However, it is often essential in order to get a start-up business going. These initial loss donations allow the business to pay for technical assistants in the initial stages of a microfinance project or for consultants for private projects. RGMIFA fund, a KFW and AFD joint initiative registered in Luxembourg, provides loans in local currency. Public operators have taken the first layer of risk that private investors could not absorb.

Isabelle Coquelle-Ricq explained that, amongst individuals, there is a demand for and a commitment in favor of a more responsible consumption. We can see that people who save money are also looking for financial products that make more sense, as shown by the growth of funds involved in SRI, social funds, revenue sharing funds or development aid funds, although the assets under management are still modest.

In 2008, **Amundi** and the AFD created a common initiative that took the form of a joint investment fund: the Amundi AFD Sustainable Future Fund, which aims at contributing to development aid by investing up to 20% in AFD bonds and 10% in PROPARCO shares, as well as some other projects in the future. The rest of the funds are invested in prudent SRI UCITS.



Questions

How can we improve the way in which development aid functions?

According to **Marc Bichler**, in 2002, the conference on financing development showed that public development aid is not sufficient. It is rather a complement to migrants' remittances and to the impact of trade.

For the EIB, development assistance is constantly being improved by the revision of different strategies and the adaptation of different procedures. We must also analyze the technical assistance associated with development aid, in order to accurately assess its effectiveness. Furthermore, **Perrine Pouget** underlined the fact that finding skills locally in order to work with efficient local service providers is not always easy. The EIB also has difficulty finding the right counterparts and stakeholders. Finally, public authorities should know when to withdraw from an operation, so that they do not substitute themselves to private investors.

Laurent Demey believes that a change in banking regulation is necessary. It is difficult for banks to gather sufficient equity to invest in countries that are not rated or poorly rated by rating agencies. These ratings discourage banks and private investors. It is therefore important to change the rules since companies in these countries often have better credit qualities than national governments. However, at the moment, it is not possible for a company to have a better rating than the State of the country in which it is located.

How can we make possible to invest in migrant projects?

Migrants face difficulties borrowing from banks both in their country of origin and in their country of residence. More and more migrants feel like down-and-outs, even though, due to their increasing number, they are a significant source of potential clients.

Why is there no development bank in Africa?

It is possible for Official Development Assistance players to contribute to the foundation of an African Development Bank in partnership with the African Diaspora, who support this type of project. However, regulations are not yet ready for this. For such an initiative to go forth, we would need to be in a position to offer investors some yield, so that they gain some confidence in the project.

Discussion on the use of migrant remittances

Bank representatives have indicated that very often migrants who transfer their money to their country of origin end up increasing the levels of consumption and do not contribute to the development of economic activity. This is why this potential resource does not attract European banks. Migrants would instead need to become involved in projects which would be capable of generating financial products and reimbursing capital. It is worth noting that Official Development Assistance could help build migrant communities.

What files does one need to apply for investments?

There are numerous economic initiatives which have been put in place using migrants' money. According to the manager of the Road Trip association (a co-operative of breeders and farmers who aim to fight desertification), these initiatives could represent around 60% of all the resources in the country. But then again, it is still difficult to pool together the required documentation. PROPARCO recognized that this is a major problem. One solution, though hard to implement and therefore unpredictable, would be to convince European banks to open agencies in Africa. We need to talk to the Banque de France to facilitate these types of operations, which have been carried out with the BGF I bank and the CBAO in order to facilitate this kind of flows.

The importance of diasporas

In France, there are 90.000 Algerian owners of small and medium-sized businesses and between 600.000 and 700.000 people from the Moroccan diaspora. If between 1 and 10% of these owners either invested in the development of their country or acted as guarantor, this could help restore France's influence at the level it used to be in certain countries such as Tunisia. This is also the condition upon which the success of the Arab spring rests: the path towards democracy will come through investment. The AFD makes funds available in Northern Africa for growing small and medium-sized businesses.

How do we explain the difficulties cooperatives face in finding investors?

Cooperatives are essentially social businesses. Their success as cooperatives prevents them from attracting external financing, since profit tends to be reinvested into the organization, which bankers or investors are likely to balk at.

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