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Clearing a Path for Global Development Finance:

Enabling Basel and Development Guarantees to Deliver on Sustainable Development Goals

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OVERVIEW

On August 2, 2017, the Milken Institute Center for Financial Markets (CFM) convened a roundtable to discuss how addressing global financial regulatory issues may foster greater G20 bank investments aligned to the U.N. Sustainable Development Goals (SDGs). In particular, discussions focused on how to improve the use of development guarantees to incentivize blended/innovative financing solutions either through enhanced guarantee structures, or reforms to the regulations and rules that govern them. The session identified three key takeaways:

1. Development organizations must understand and align the roles of local and international capital;

2. Guarantees offer promising opportunities, but must recognize and reshape banks' market incentives and operational constraints to spur increased SDG-aligned investment;

3. Data and appropriate risk management must drive any proposed global financial regulatory reforms.

Although this initial paper includes direct opinions culled from all discussants (G20 banks, bilateral and multilateral guarantors, development finance institutions and Basel experts) it does not contain directly attributable content.

Based on feedback to this summary, a set of comprehensive considerations will be prepared and shared with the Blended Finance Task Force, a group established by the Business & Sustainable Development Commission to deliver recommendations for financing the SDGs at Davos in January 2018. Additionally, CFM will circulate these recommendations to other working groups that are informing the Bank of International Settlements (BIS), the Financial Stability Board (FSB), and the G20 regarding the unintended consequences of financial regulations on developing and emerging markets.

BACKGROUND CONTEXT

Through the SDGs, global stakeholders have converged on an ambitious set of objectives to end poverty, protect the planet, and engender prosperity for all. Current estimates suggest an annual need for $2.5 trillion in new investments, over and above current commitments. The top 600 international banks held approximately $4.2 trillion more in capital than required by Basel guidelines at the end of 2016. There is considerable merit to incentivizing global financial institutions to become more active partners in financing SDG-aligned investments. To allay the risk of investing in developing countries, the bilateral and multilateral donor and DFI communities have been providing credit enhancement tools (i.e., development focused guarantees) in a limited way. For example, analysis of multilateral institutions indicates that guarantees represent approximately only 5% of their commitments but generate approximately 45% of their private-sector mobilization.[1]

[1] Mobilization data from 2015 DAC survey and commitment data from 2015 annual reports.

Many of the factors limiting the utilization of these tools stem from the misalignment of the global regulatory architecture for financial institutions and the incentives underpinning development organizations. In particular,

development guarantees do not always closely align with the policies and regulations that govern financial institutions, such as obligations prescribed by the Basel accords. Unless corrected, our ability to achieve the SDGs may be limited.

With this challenge in mind, CFM convened expert stakeholders to discuss how global financial regulatory issues may inhibit G20 banks from making SDG-related investments and to establish actionable recommendations for addressing these issues through blended/innovative financing solutions, regulatory reform, or both. It is expected that these recommendations will inform various ongoing processes to improve the development and financial systems.

KEY DISCUSSION POINTS

1. Development organizations must understand and align the roles of local and international capital.

While the SDGs are a universal set of objectives, there is not a common set of incentives across development organizations and market participants. Due to their scale and position, G20 banks can play a vital role in a solution, but they do not represent the only piece of the puzzle. An important way to expand funding for the SDGs is to broaden investor participation. Expanding requires an appropriate mix of policies and reforms that recognize and address the priorities and limitations of local capital sources, international capital providers, and development organizations. The roundtable discussed a variety of issues that prevent strong linkages among these actors, as well as strategies that development institutions can employ to bridge the gaps between complementary sources of capital:

G20 banks have pulled back from developing markets. Compliance thresholds and regulatory oversight have increased since the 2008 financial crisis. These factors negatively impacted bankers' rationale for operating in developing markets. As such, most G20 banks have pulled back from direct operations in developing markets, either employing a limited correspondent banking model or exiting altogether. Additionally, socially beneficial projects exist in developed markets; because macro certainty and liquidity are lower in developing markets, it is not necessarily justifiable or strategic to pursue socially beneficial projects in these areas.

Local institutions must be the first mover in galvanizing SDG investment. Although developing market banks and institutional asset managers are insufficiently scaled to fulfill the lofty funding needs of the SDGs, they are the natural first movers in addressing local challenges. Armed with intimate knowledge of the operating

environment and without a need to deal with foreign currency and other expensive risks inherent to international finance, their resources can be deployed more nimbly to jump start a solution process. But local institutions are under-investing in the real economy, and instead focusing on government securities. This sends a negative signal about the opportunity set to international institutions that might consider investing in the market.

Development organization support for local institutions can be a catalyst for progress. For G20 capital providers to take notice of developing markets, local asset allocation must first demonstrate an unfulfilled opportunity. Unfortunately, there is a vicious cycle occurring in many developing markets that prevent a strong, stable, and scaled private-sector lending opportunity. High yielding government securities eliminate the pressure on local financial institutions to seek out private-sector investments because the return differential does not justify the added risk. Development organizations can address this through various forms of support to local financial institutions. By providing guarantees to local financial institutions, development organizations could help justify the rationale for private-sector lending. Similarly, by purchasing certain long-held troubled assets, development organizations could free up local resources for investing in new private-sector opportunities. Ultimately, while the supply of capital is not the only side of the issue, local institutions must allocate capital to the private-sector at a ratio more in line with developed market levels to signal a need for international capital.

G20 banks see their role as a channel for international institutional capital. G20 banks represent only one of several large pools of money in the global financial system. Assets held by institutional investors, such as pension funds and the insurance industry, also dwarf global SDG needs. These industries' appetites for long-term risk is perhaps better suited for development. But the involvement of banks, as primary creators and sellers of financial products, is key to

unlocking institutional investor resources in support of the SDGs. To prove the merit of developing markets, G20 banks must be convinced that the opportunity satisfies their own balance sheet needs and, of equal importance, that it is saleable to their institutional investor client base. If properly structured, risk mitigation tools provided by development organizations hold the potential to satisfy these two tests.

Institutional capital also requires risk mitigation. Although institutional investors typically do not directly answer to the Basel regulatory regime and can commit capital on a longer-term basis than banks, they also require risk mitigation to invest more actively in developing markets. At its core, this is driven by their fiduciary responsibilities. Institutional investors must be able to prove that they exercise careful due diligence and allocate risk to a prudent standard. Regardless of whether investing directly in projects or through products manufactured by banks, independent credit ratings are a critical tool in justifying an investment decision. Given the country ratings and lack of historical data involved in most developing market investment opportunities, development organizations can provide important tools for generating a credit rating that allows international institutional investors to participate.

Development organizations' theories of change need to be flexible. As the only set of organizations with a direct mission to fulfill the SDGs, it is the role of the development community to incentivize the participation of a wide range of investors that have only indirect interests in the process. Critical to that is a recognition that all institution types have unique regulatory rigidities that make them respond differently to the same incentives. Local capital sources, international banks, and institutional investors each have their limitations when considering a role in funding the SDGs. Therefore, development organizations must be the flexible partner in the equation and create products and approaches that adapt to the risks of the specific organization they are seeking to activate.

Third party vehicles and platforms can be helpful tools but potentially create permanent distortions. Given that the full value of guarantees does not count toward Organisation for Economic Co-operation and Development (OECD)[2] pledges in the way that grants do, some bilateral donors have looked to support multilateral organizations or create special purpose vehicles as conduits rather than provide guarantees directly. There are considerable lessons for how to leverage guarantees effectively via the experience of vehicles such as GuarantCo, a guarantee organization backed by many European development institutions. There are also lessons to be learned from instances in which these third parties lived beyond their utility and became entrenched market distortions. Any effort to create or leverage third-party vehicles must be grounded in the cost-benefit tradeoff of near-term results and long-term market distortions.

[2] Participating countries have pledged 0.7% of their Gross National Income to foreign aid.

2. Guarantees offer promising opportunities but must recognize and reshape banks' market incentives and operational constraints to spur increased SDG-aligned investment.

Guarantees offer an opportunity for development institutions to leverage private capital for development, yet represent only a small piece of their activity. According to a CFM analysis of multilateral institutions, which have prioritized guarantees more than bilateral organizations, more than 45% of their private-sector leverage can be attributed to the 5% of their commitments dedicated to guarantees. Discussants identified several factors that could explain the marginal use of guarantees for catalyzing private bank lending:

Development institutions primarily are funders. Development institutions have historically relied on direct funding solutions. Organizations that distribute official development assistance (ODA) are under pressure to meet OECD pledges, and guarantees do not get equal treatment with direct funding. While OECD is working to

correct this accounting asymmetry through the TOSSD initiative[3], as it stands today, there is more incentive to engage in grants than credit products. Similarly, development finance institutions were initially set up to be lenders and financing products, rather than guarantees or insurance, remains the core of their business.

Development institutions have limited risk tolerance. Despite their development mandates, development institutions are not incentivized to take on outsized risk. Aid agencies are not willing to absorb heavy, or even moderate, losses on their credit programs. Reporting poor performance is politically challenging, and also undermines their ultimate mission of proving the commercial merit of developing markets. Development finance institutions have the added burden of needing to be self-sustaining. This burden reinforces the imperative to invest in lower risk opportunities and to focus on higher-return products such as loans and equity investments rather than guarantees.

Guarantees only address certain risks and cover them on a partial basis. Current guarantee products typically cover only credit or political risks and do so on a partial basis. This raises two issues for banks. First, for business and regulatory reasons, banks aim to isolate fully and transfer risk, so it is not easy to assess the value of a guarantee contract that shares risk instead. Second, it is not only credit and political risks that prevent banks from lending to development projects. Issues like ineffective legal systems and dealing in illiquid currencies are also challenges, and without addressing the full spectrum of risks, guarantees can not necessarily improve loan economics.

Guarantees need to provide certainty and pay on demand. For policy and operational reasons, public-sector guarantors are compelled to include provisions that decrease the certainty and speed of claim payments. Examples such as unilateral termination rights[4], although rarely invoked, prevent banks from gaining the

[3] The Total Official Support for Sustainable Development (TOSSD) initiative aims to increase transparency and monitoring of the development finance landscape by including the use of risk mitigation instruments in development cooperation.

[4] Many government guarantors must include the ability to terminate for convenience should their foreign policy priorities or relationship with a particular country change. If invoked, the then outstanding loan balance would be covered, but any future loan drawdowns would not be covered, which impacts the project and the certainty of a lender's revenue stream.

level of certainty needed for capital relief from a regulatory perspective. Similarly, rather than paying on demand, or before loan acceleration, many guarantors prefer to pay claims after a bank's collection efforts. A guarantee that requires such collection efforts has implications on a bank's liquidity, and therefore has a negative impact on its financial statements and reduces the attractiveness of the guarantee.

Guarantees need to allow for seamless exits. G20 banks typically do not want to hold loans to maturity. This is particularly true for longer tenors, which create asset-liability mismatches for banks with deposit-based funding structures. Although guarantees typically do include assignment and transfer rights, the process usually requires guarantor approval of the potential assignee. Therefore, originating banks cannot easily or quickly sell their exposure, and this directly reduces the attractiveness of guaranteed loans to risk managers and regulators who focus on the illiquidity of the particular asset. Although achieving true tradability of development guarantees is perhaps not feasible in the near term, streamlining their assignment and transfer provisions to provide clean exit mechanisms could be an important step to activating banks and capital markets.

3. Data and appropriate risk management must drive any proposed global financial regulatory reforms.

The job of financial regulators is to create and enforce rules that ensure the stability of the global financial system. Although financial regulations have intended and unintended consequences outside the financial system, any appeal for changes to mitigate those consequences must be argued for in terms that reinforce effective risk management. Said another way, financial regulators are not tasked with making sure banks alleviate poverty, so if the development community hopes to enlist the support of banks through the use of guarantees, proposed reforms must meet the

primary needs of regulators and not compromise macro stability. Participants discussed several key potential regulatory reforms related to risk weighting and liquidity, as well as the factors that would influence the likelihood of success:

Developing markets lack data to prove a difference between real and perceived risk. Financial regulations are designed to identify and quantify risks so they can be better managed. The key to calibrating and managing risk is the supporting data set that shows actual loss experience. Unfortunately, almost by definition, developing markets lack the historical performance data to illustrate that the real risk of lending is different than the risk contemplated by existing rules. Indeed, there is a vicious cycle in which perceived risk limits deal flow, which in turn limits building a more robust data set. Therefore, successful reforms must focus on proving that guarantees provided by development organizations sufficiently transfer whatever risk there may be outside the purview of financial-sector regulators.

Guarantees may be able to counter the effect that country risk weightings have on developing markets. Exposures to projects and institutions outside of OECD countries carry increased risk weighting under Basel guidelines. As a result, regardless of the strength of particular project or institution, exposure to a developing country jurisdiction has an immediate and significant disadvantage from a bank's capital perspective. If structured appropriately, guarantees issued by G20 countries could potentially mitigate country risk by transferring risk (rather than sharing) from the lender to the guarantor, and thus eliminate the additional capital charge for developing market jurisdictions.

Guarantees should seek to address bank liquidity guidelines. By 2019, when Basel III is completely phased in, banks will be required to hold a stock of high-quality liquid assets (HQLA) that fully covers their next month's projected net cash outflows. Compared to the 60% banks were required to cover until 2016, this increased

requirement will significantly reduce banks' appetite for illiquid exposures. To counteract this effect, guarantees could be structured such that the SDG-exposures they are covering qualify as HQLA, and preferably Level 1 HQLA. Level 1 HQLA generally include cash and central bank reserves, as well as certain marketable securities backed by sovereigns, central banks, or other high credit quality institutions. Although they are provided by G20 governments, development guarantees currently do not qualify for HQLA treatment because they are not sufficiently tradable or transferable. Enhancing guarantee transferability is a policy and operational matter for development organizations that could be rectified.

CONCLUSION

The Milken Institute, acting as a neutral arbiter, seeks partners to join the effort to develop pragmatic solutions to address global financial regulatory issues and foster greater G20 bank investments aligned to the SDGs. Of particular importance is fostering ideas on how to improve the use of development guarantees to incentivize blended/innovative financing solutions, either through enhanced guarantee structures or reforms to the regulations and rules that govern them.

The August 2 roundtable identified justifiably different objectives of the various stakeholders. Development organizations are driven by SDG impact, financial institutions are driven by commercial results and fiduciary responsibilities, and regulators are driven by a mandate to ensure stability in global financial markets. Nonetheless, all elements of the ecosystem are critical, and participants agreed that there are potential areas of collaboration where an increased impact is possible without compromising stability.

These collaborative engagements are timely for potentially influencing not only ongoing Basel III implementation but also the debate on unintended consequences of financial regulation in developing and emerging markets and the upcoming Blended Finance Task Force report expected in January 2018. Now more than ever, third party insights, perspectives, and analysis of unintended consequences can play a vital role in helping to shape the path forward for the BIS, FSB, and other key stakeholders.

To that end, CFM will be building on the insights of roundtable participants and other partners to conduct more robust research aimed at identifying best practices of guarantee structures and achievable regulatory refinements that can improve the ability of all stakeholders to work together to end poverty, protect the planet, and engender prosperity for all.

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