Australian Sustainable Finance Institute

# Submission to the Australian Government's Development Finance Review

The Australian Sustainable Finance Institute (ASFI) welcomes this opportunity to contribute perspectives to the Government's Review of Development Finance.

ASFI represents Australian financial institutions – including major banks, superannuation funds, insurers, asset managers, and financial services firms – that are committed to aligning the Australian financial system with a sustainable, resilient, and inclusive Australia. Australia's security, prosperity and wellbeing is inextricably linked to that of the region in which we are situated. As such, ASFI's mandate extends beyond Australia's shores to consider opportunities for financial institutions, markets, and policy to support and accelerate sustainable development in the Asia-Pacific.

ASFI welcomes the Government's Review into Development Finance options to support Australia's foreign policy, trade, security and development objectives and help countries in our region achieve their development and climate objectives (the "Review").

ASFI members collectively hold over AU$17 trillion in assets under management. They are committed to allocating this capital in a way that supports positive social and environmental outcomes. Blended finance – the use of public funds to attract private finance and investment into priority areas – has significant potential to mobilise institutional capital into activities, companies and infrastructure that provide jobs and improve livelihoods in key sectors such as climate and clean energy, financial services, infrastructure, and agriculture.

*Scope of this submission*

The terms of reference for the Review refer to both sovereign lending (i.e. loans from the Australian Government to other Governments) and private sector finance (i.e. finance of or investment in private companies or projects). It is useful to consider the two separately because they typically have different objectives and require a different set of considerations, different institutional arrangements and different skill sets and capabilities to design and implement:

- Sovereign lending is usually done to support Australia's bilateral relationships with countries in our region i.e. for geo-strategic objectives. It does not crowd in finance from other sources because the recipient is a sovereign entity and the loan is generally to provide government budget support or support infrastructure that is uncommercial.
- Private sector lending or investment by government vehicles is usually done to support partner countries' climate and development objectives.[1] When appropriately designed it can crowd in finance from other sources including institutional investors (such as ASFI members), non-institutional private investors (like high-net-worth investors, family offices and foundations), and philanthropic organisations.

This submission focusses exclusively on private sector finance because these have the potential to mobilise additional capital to achieve development, trade and investment objectives of the Australian Government. This submission uses the term "Blended Finance" to refer to financial mechanisms and structures that use public money to increase private sector finance and investment in sustainable development.[2]

*Private finance in the Asia-Pacific – challenges and opportunities*

The Asia-Pacific, and particularly South and Southeast Asia, represent large and growing markets with significant investment potential. Nevertheless, Australian financial institutions typically invest mostly or exclusively in Australia and other OECD markets which are familiar and well-established and have streamlined governance and approvals processes.

While there is an appetite from Australian institutional capital to pursue opportunities in the region, there are significant barriers to doing so. The barriers include: political and governance risk, lack of liquidity, lack of scale, uncertain returns, unfamiliar markets, high transaction costs, currency risk, and lack of investible pipeline. Investing in these markets requires financial institutions to resource deal teams with appropriate expertise and regional presence. Transactions tend to take a longer time to reach financial close, and the percentage of successful transactions (ones that end up going ahead) is lower than in domestic or other OECD markets. All of this means the risk-return profile of investment opportunities in the Asia-Pacific less attractive than the risk-return profile of opportunities in OECD markets, so capital is less likely to flow.

*What can Government do?*

Government financing vehicles can help address the barriers outlined above by investing in a way that improves the risk-return profile of a given transaction for private capital by 'de-risking' the deal. 'De-risking' does not necessarily require a large financial contribution from

[1] While not the primary objective, these mechanisms can also support broader foreign policy objectives including trade and investment, and help position Australia as the 'partner of choice' of countries in the region.
[2] Convergence Blended Finance Network provides a useful definition and overview: Blended Finance | Convergence

the public sector: in many cases, only an incremental improvement in the risk-return profile is required to change the decision of an investor or financier.

Examples of ways in which government finance can de-risk to mobilise private capital:

- Government can provide **equity** in a transaction so that institutional investors can co-invest using debt (which is less risky and has more certain returns).
- Government-provided **guarantees** offer a range of different ways to de-risk and can be targeted to take on specific risks. For example, the US International Development Finance Corporation offers guarantees to cover the political risk of transactions in emerging markets for US private investors. These guarantees may never be called on but provide confidence that losses associated with this risk will be covered if certain events do occur, giving the private sector the confidence to invest.
- Government can help provide the **scale** (i.e. ensure transactions are large enough in dollar terms) that institutional investors seek by aggregating smaller projects or companies in funds or other structures, and bearing the costs of establishing these.
- Government can issue **fixed income products such as bonds** where investors are given a stable, predictable return and government can invest the proceeds in high impact companies and projects in the region.
- Government can **create deal pipeline** by investing in companies or projects at an early stage. For example, public finance is often needed for infrastructure projects during the development and construction phases. Private sector finance can step in once the project is operational, freeing up public funds to be re-invested elsewhere.
- Importantly, Government finance vehicles can provide significant **in-kind and technical support** through deal sourcing, access to local partners, and technical due diligence and expertise in particular areas (e.g. clean energy). This assistance reduces transaction costs for private capital, improving the attractiveness of an opportunity.

Government has an important role to play in providing these types of support in under-developed markets. Over time, markets would typically become more established so that the private sector can participate without government support.

*Australian experience in Blended Finance'*

Australia is unique among many of its developed country peers in not having a dedicated international development finance institution ("DFI"). However, Australia does have valuable experience in designing and implementing domestic public finance vehicles designed to mobilise private capital:

- The Clean Energy Finance Corporation (CEFC) is a good example of how public finance can provide both the technical expertise and the flexible capital to build markets and crowd-in private capital for clean energy development and deployment.

- The National Housing Finance and Investment Corporation (NHFIC) has likewise supported private investment into social housing in Australia by issuing Australian Government backed bonds to provide loans to community housing providers.

Internationally, DFAT has made some good first steps in Blended Finance through its Emerging Markets Impact Investment Fund and the Private Infrastructure Development Group. These initiatives encourage private co-investment by de-risking transactions, and build a pipeline of companies and projects with strong development impact for private capital to invest in at a later stage of the company/project life.

*Recommendations*

ASFI recommends:

- The Government should expand its use of Blended Finance with the explicit aim of mobilising private capital (including institutional capital, other private investors, and philanthropic capital) into the Asia-Pacific region to support the net zero transition and other development objectives. By bringing significant amounts of Australian private capital alongside its own capital, the Australian Government can upsize its development results which will enhance Australia's ability to be a "partner of choice" in the region, particularly in South and Southeast Asia where partner countries are eager to attract foreign direct investment and portfolio inflows.

- Government should develop a dedicated Blended Finance capability that can provide flexible capital, regional expertise and sectoral/development expertise, and enable investment opportunities for private capital – including Australian financial institutions – that are aligned with Australian Government objectives. This capability would complement (but not supplant) existing grant financing tools and programs through the Australian aid program. It should be separate from Australian Government sovereign loans or sovereign infrastructure financing facilities.

    - As an immediate step, existing high-performing Blended Finance mechanisms could be scaled up. This includes the Emerging Markets Impact Investment Fund, and the Private Infrastructure Development Group. These could be scaled up to invest across all sectors or with a particular focus on priority areas for the Australian development cooperation program – for example climate and clean energy and gender lens investing. As part of this scale up, DFAT and its implementation partners should invest in making stronger connections with Australian investors and financiers to understand their investment processes and preferences, and to show-case the investment opportunities that are available through Australian Government mechanisms.

    - In parallel, Government could commission an updated market scoping to build on and update the work done in the Eyers report. This could assess the scale and type of opportunities for private capital and the types of Blended Finance mechanisms required for private capital to move into these in the region. The starting point for this market scoping needs to be a clear articulation of the development challenges Government is seeking to address with private capital so that boundaries and scope of this work are clear.

    - Once operational, the new Blended Finance capability should take over management of existing DFAT Blended Finance mechanisms. DFAT should continue to play an important role in allocating grant funding for complementary market building activities through the Australian development assistance program.[3]

In designing a new, dedicated development finance capability, Australia should apply the following principles:

- **Fit for purpose institutional and governance arrangements:** A new dedicated Blended Finance capability should be appropriately resourced, and be implemented using fit-for-purpose institutional arrangements. Specifically:
    - It should be separate to DFAT and at arm's length from Government decision-making. This would help to: avoid political influence in investment decisions; ensure that investments are consistent with the objectives of the institution; and ensure that commercial timeframes are able to be met (this is critical to mobilising private capital).
    - It should focus on private sector financing and not be co-located with sovereign financing capabilities, which require a different set of expertise and considerations.
    - It should recognise that Blended Finance requires a combination of commercial finance and investment skills, and development and impact management skills.

  Existing Australian international financing vehicles such as Export Finance Australia and the Australian Infrastructure Financing Facility for the Pacific are not in their current form appropriately constituted or resourced to carry out Blended Finance functions. Likewise, the Department of Foreign Affairs and Trade – as a primarily foreign policy and diplomatic agency – does not have the expertise, culture or institutional independence to design and implement an Australian Blended Finance capability of significant scale.

  Other jurisdictions with DFIs, including the US, UK, Germany, and France, have typically chosen to establish a new institution to carry out this function. Establishing a new institution enabled by legislation (in much the same way as Australia created the Clean Energy Finance Corporation) would help ensure operational independence and a culture and workforce that combines commercial nous with a focus on impact. It would also enable the institution to take a longer-term view of the development of

[3] DFAT currently supports a range of programs that do this including: the Private Finance Advisory Network; Convergence Blended Finance Network; and Investing in Women.

financial markets in our region. All these features are critical for mobilising private capital.

- **Additionality:** the capability should be designed and implemented with an express goal of achieving development impact through mobilising private capital in markets which are *under-serviced by commercial finance actors*. It should use instruments that allow it to be additional to commercial finance by accepting higher risk or lower returns (for example by providing guarantees or taking equity stakes that de-risk commercial debt). And it should provide the technical expertise and local networks to support private investors and financiers to assess and manage risk in unfamiliar markets.
- **Flexibility:** the new capability should have a mandate sufficiently broad to allow it to respond and adapt to an evolving environment and the development of the financial sector in key markets. For example, it should not be limited to investment in infrastructure only, or to a particular sector. It should be capable of financial innovation and be able to creatively develop and deploy investment products that encourage private finance participation.
- **Learn from domestic and international experience**:
    - Australia can learn from its domestic experience in designing and implementing catalytic or market-building finance vehicles like the CEFC or NHFIC. Many ASFI members have experience providing finance or investment alongside these and other Australian Government financing vehicles and could provide input into the design process.
    - Most of Australia's developed country peers have their own DFI. Many DFIs have undergone significant change in recent years in an effort to become more development focussed and more additional to private sector activity. Australia has the opportunity to learn from these examples and experiences to create a blended finance capability that is truly fit for purpose, complements multilateral development banks, and maximises Australia's value – helping to promote Australia as the partner of choice for countries in our region.